NAIC National Association of Insurance Commissioners

Date:3/11/2020

2020 Spring National Meeting
Conference Call

VALUATION OF SECURITIES (E) TASK FORCE

Thursday, April 9, 2020
3:00 p.m. – 4:00 p.m. ET / 2:00 p.m. – 3:00 p.m. CT / 1:00 p.m. – 2:00 p.m. MT / 12:00 noon. – 1:00 p.m. PT
Diamond Pass Call - http://dpregister.com/10140308

ROLL CALL

Robert H. Muriel, Chair	Illinois	Chlora Lindley-Myers	Missouri
Doug Ommen, Vice Chair	Iowa	Bruce R. Ramge	Nebraska
Lori K. Wing-Heier	Alaska	Marlene Caride	New Jersey
Ricardo Lara	California	Linda Lacewell	New York
Andrew N. Mais	Connecticut	Jessica Altman	Pennsylvania
Trinidad Navarro	Delaware	Kent Sullivan	Texas
David Altmaier	Florida	Todd E. Kiser	Utah
Dean L. Cameron	Idaho	Scott A. White	Virginia
Vicki Schmidt	Kansas	Mike Kreidler	Washington
James J. Donelon	Louisiana	Mark Afable	Wisconsin
Al Redmer Jr.	Maryland		
Gary Anderson	Massachusetts		

NAIC Support Staff: Charles A. Therriault

AGENDA

1. Consider Adoption of its Fall 2019 National Meeting minutes, and February 04, 2020 minutes — Attachment A, Attachment B
—Kevin Fry (IL)

2. Consider Adoption of an Updated Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) of Instructions to Map Financial Modeled RMBS/CMBS Security NAIC Designations to NAIC Designations Categories *(Doc. ID 2019-016-02)* — Attachment C & C-1 – C-5
—Kevin Fry (IL), Charles Therriault (NAIC), Eric Kolchinsky (NAIC)

3. Consider Adoption of a Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Offic*e (P&P Manual) for Principal Protected Notes with an Updated Definition and Instructions *(Doc. ID 2019-015-01, Doc. ID 2019-015-02)* — Attachment D & D -1-D-9
—Kevin Fry (IL), Charles Therriault (NAIC), Eric Kolchinsky (NAIC)

4. Receive IAO Issue Paper on Staff Concerns about Bespoke Securities and Reliance on CRP Ratings *(Doc. ID 2020-018-01, 2020-018-02)* — Attachment E & E-1
—Kevin Fry (IL), Charles Therriault (NAIC), Eric Kolchinsky (NAIC)

5. Hear a Staff Report on Projects Before the Statutory Accounting Principles (E) Working Group
—Kevin Fry (IL), Julie Gann (NAIC)

6. Hear a ACLI Report on LIBOR Phase Out and Transition
—TBD (ACLI)

7. Hear an IAO Staff Report on the Infrastructure Investments Study
—Eric Kolchinsky (NAIC)

8. Hear a Staff Report on the Year-end Process and Carry-over
—Charles Therriault (NAIC)

9. Adjournment

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Draft Pending Adoption

Draft: 12/16/19

Valuation of Securities (E) Task Force
Austin, Texas
December 8, 2019

The Valuation of Securities (E) Task Force met in Austin, TX, Dec. 8, 2019. The following Task Force members participated: Robert H. Muriel, Chair, represented by Kevin Fry (IL); James J. Donelon, Vice Chair, represented by Stewart Guerin (LA); Lori K. Wing-Heier represented David Phifer and Wally Thomas (AK); Andrew N. Mais represented by Kathy Belfi and William Arfanis (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Ray Spudeck and Carolyn Morgan (FL); Doug Ommen represented by Carrie Mears (IA); Vicki Schmidt represented by Tish Becker and Joe McGarry (KS); Gary Anderson represented by John Turchi (MA); Al Redmer Jr. represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Bruce R. Ramge represented by Lindsay Crawford and Justin Schrader (NE); Marlene Caride represented by John Sirovetz (NJ); John G. Franchini represented by Lea Geckler (NM); Glen Mulready represented by Eli Snowbarger (OK); Jessica Altman represented by Kimberly Rankin (PA); Kent Sullivan represented by Jamie Walker and Amy Garcia (TX); Todd E. Kiser represented by Jake Garn and Reed Stringham (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Patrick McNaughton (WA); and Mark Afable represented by Randy Milquet (WI).

1. <u>Adopted its Oct. 31, Sept. 5 and Summer National Meeting Minutes</u>

Ms. Belfi made a motion, seconded by Mr. Phifer, to adopt the Task Force's Oct. 31 (Attachment One), Sept. 5 (Attachment Two) and Aug. 4 (*see NAIC Proceedings – Summer 2019, Valuation of Securities (E) Task Force*) minutes. The motion passed unanimously.

2. <u>Heard a Staff Report on Projects Before the Statutory Accounting Principles (E) Working Group</u>

Mr. Fry said the next item on the agenda is to hear a report on projects before the Statutory Accounting Principles Working Group from Julie Gann (NAIC).

Ms. Gann said the purpose of the update aligns with the coordination efforts between the Working Group and the Task Force. She highlighted a few items to the Task Force, beginning with the adopted items:

- <u>Other Derivatives</u> – The Working Group adopted revisions to clarify that other derivatives—which are derivatives that are not used in hedging, income generation or replication transactions—shall be reported at fair value and nonadmitted.

- <u>Goodwill</u> – For subsidiary, controlled and affiliated investments (SCAs), the Working Group adopted minor revisions to clarify that goodwill from an insurance entity acquisition of an SCA is subject to the 10% adjusted capital and surplus limit, regardless if the goodwill had been "pushed down." The Working Group re-exposed the agenda item considering pushdown to provide more time for the industry to provide examples on the application of pushdown.

- <u>Wash Sales</u> – The Working Group adopted revisions to clarify that the wash sale disclosure shall only include wash sale transactions that cross reporting periods. Insurers are currently reporting wash sales that occur inter-quarter (for example, sell in January, purchase back in February). There is no need to report that transaction in the wash sale disclosure.

Items Exposed by Working Group:

- <u>Preferred Stock</u> – The Working Group exposed a revised issue paper and proposed substantively revised *Statement of Statutory Accounting Principles (SSAP) No. 32R—Preferred Stock* as part of the investment classification project. The overall project proposes to revise definitions, measurement and impairment guidance for these investments. The issue paper was revised to consider a number of the industry comments received from the past exposure.

- <u>Related Party Transactions</u> – The Working Group exposed two separate agenda items focusing on related party transactions. The first agenda item proposes to data-capture existing disclosures in accordance with *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*. Affiliate transactions already captured in Schedule Y would not need to be duplicated in these disclosures, but the data-capture would collect

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information on related party (non-affiliate) transactions. These disclosures already exist in narrative form but are not currently data-captured. The second exposure clarifies the types of entities that are included as related parties, clarification that non-controlling ownership interest greater than 10% is a related party subject to related party disclosures, and guidance for disclaimers of affiliation and control for statutory accounting. Although an entity may have a disclaimer of control, the edits clarify that the entity is still a related party. These two items are being addressed separately to ensure that the data-capturing of disclosures is available for year-end 2020.

- Working Capital Finance Investments – The Working Group exposed substantive revisions to *SSAP No. 105—Working Capital Finance Investments* as directed by the Working Group at the Summer National Meeting. These revisions reflect six of the recommendations provided by the industry and referred from the Task Force.

- Qualifying Cash Pools – The Working Group exposed revisions to *SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments* to incorporate concepts to allow cash pools to be reported as cash equivalents. The proposed revisions will only allow cash pools that meet certain criteria for this reporting.

- Rolling Short-Term Investments – The Working Group exposed revisions to SSAP No. 2R to incorporate principle concepts in classifying investments as cash equivalents or short-term investments. This exposure intends to limit the amount of time an investment can be reported as a short-term investment. For investments that are expected to terminate after 364 days and are renewed for another 364 days, this proposal would no longer allow that to be reported as a short-term investment. There are specific exclusions to this guidance to avoid unintended consequences for short-term investments like cash pools that are expected to be regularly renewed and rolled. As such, the proposed revisions would not include any nonaffiliated *SSAP No. 26R—Bonds* investments. It would include affiliated SSAP No. 26R investments, all *SSAP No. 43R—Loan-Backed and Structured Securities* investments and anything that would be reported as a Schedule BA investment if not reported as short-term.

- Financial Modeling – SSAP No. 43R – The Working Group exposed revisions to eliminate the financial modeling guidance from SSAP No. 43R, noting that this exposure was contingent on the Task Force taking a similar action. The Working Group will not consider adoption action on this guidance until after the Task Force takes final action.

- Financing Derivatives – The Working Group exposed revisions for the reporting of derivatives with financing premiums. With the exposed revisions, the gross value of the derivative—without reflection of financing components—would be reported for the derivative on Schedule DB. The financing provisions (e.g., liability for derivative) would be reported separately.

- Equity Instruments in SSAP No. 43R – The Working Group did not discuss the agenda item for equity instruments in SSAP No. 43R. A conference call is scheduled for Jan. 8, 2020, for this discussion. The comment deadline is Jan. 31, 2020.

3. Received and Exposed a Nonsubstantive Proposed P&P Manual Amendment to Reflect the SEC's Adoption of a New Rule to Modernize Regulation of Exchange-Traded Funds

Mr. Fry said that on Sept. 26, the U.S. Securities and Exchange Commission (SEC) adopted Rule 6c-11 under the Investment Company Act of 1940, for exchange-traded funds (ETFs). Mr. Fry asked Marc Perlman (NAIC) to give a brief update on this change and proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual).

Mr. Perlman said Rule 6c-11 will permit ETFs that satisfy certain conditions to operate without first obtaining an exemptive order from the SEC under the Act. The SEC has stated that the intent of the rule is to modernize the regulatory framework for ETFs by reducing expenses and delays in creating new ETFs; promoting greater consistency, transparency and efficiency for ETFs; and facilitating greater competition among ETFs. The rule becomes effective Dec. 23, followed by a one-year transition period for compliance.

Mr. Perlman noted that ETFs contain certain features that distinguish them from the types of investment companies originally contemplated by the Act and its rules and, therefore, have needed to rely on SEC exemptive orders to operate as investment companies under the Act. The new rule will end the need for most exemptive relief. Additionally, the rule permits ETFs to use "custom baskets" that do not reflect a pro rata representation or representative sampling of the ETF's portfolio holdings, and the SEC is rescinding current ETF marketing restrictions. In order to rely on the new rule, an ETF must satisfy a new definition of ETF and various conditions, including: updated website disclosures (such as historical net asset value (NAV), premium and discount, and bid-ask spread information), and adoption of policies and procedures that govern the construction and acceptance of baskets.

The new rule will rescind the exemptive orders from existing ETFs, which will be able to rely on the rule going forward. However, certain categories of ETFs will not be covered by the rule, including leveraged ETFs, inverse ETFs, ETFs organized as unit investment trusts (UITs), share class ETFs and non-transparent active ETFs. The SEC expects the "vast majority" of ETFs to be covered by the rule.

Mr. Perlman said the NAIC Securities Valuation Office (SVO) takes the position that because the new rule primarily affects SEC exemptive relief and ETF reporting and disclosure, it will not impact the quantitative and qualitative factors the SVO considers when analyzing ETFs. As such, the SVO recommends nonsubstantive P&P Manual amendments to remove references to SEC exemptive orders from descriptions of ETFs and clarification that Regulatory Treatment Analysis Service (RTAS) application filers only need to provide SEC exemptive orders to the SVO to the extent they are applicable.

Ms. Mears made a motion, seconded by Ms. Belfi, to receive this P&P Manual amendment to remove references to SEC exemptive orders from descriptions of ETFs and clarification that RTAS application filers only need to provide SEC exemptive orders to the SVO, to the extent they are applicable, and to expose this proposed amendment for a 45-day public comment period ending Jan. 23, 2020. The motion passed unanimously.

4. Adopted a Proposed P&P Manual Amendment to Add Instructions for GLF Transactions

Mr. Fry said the next item on the agenda is a substantive proposed amendment to the P&P Manual to add instructions for ground lease financing (GLF) transactions. This is a joint proposed amendment was exposed during the Task Force's Oct. 31 conference call for a public comment period that ended Nov. 22.

Mr. Fry said the SVO became aware that certain insurance company filers were submitting credit tenant loan (CTL) transactions and transactions—which the SVO is now calling GLF transactions—through the filing exempt (FE) process. The SVO considers GLF transactions distinct from CTL transactions. The SVO studied the GLF transactions, working closely with the industry, several of whom agreed to jointly sponsor this proposed amendment. He asked Mr. Perlman to provide a summary of the proposal.

Mr. Perlman said the amendment recommends a "decision-tree" approach to analyzing GLF transactions. First, the SVO would analyze the ground lease to determine if it meets the P&P Manual CTL criteria (meaning it is "hell or high water" or "triple net"). Second, the SVO would determine if the sub-leases would similarly meet the CTL criteria and, if so, potentially review the transaction as akin to a CTL. Third, if the SVO cannot look at the whole structure as akin to a CTL, the SVO would work with the NAIC Structured Securities Group (SSG) to determine if SSG can model the sub-leases or business operation like it would a commercial mortgage-backed security (CMBS). And, lastly, if the SSG determines that it cannot model the sub-leases or business operation, and if the GLF transaction has been assigned a rating by a rating agency, the SVO can use the rating agency analysis to assist in its analysis. The SVO's analysis will be entirely at the discretion of the SVO, and the SVO will be under no obligation to accept the rating agency analysis, conclusions or ratings. Most GLF transactions are expected to fall in this final category.

Mr. Fry said this effort is the best of what the Task Force does when it coordinates with the industry, noting that the SVO staff worked closely and had several meetings with the industry to come to an amicable solution. This all started from a spot in the P&P Manual that identifies which securities are not eligible for filing exemptions. CTLs are not eligible for filing exemption and are securities that do not fit the definition of CTLs but are still in the spirit of a CTL. It is this subset of securities for which the Task Force needed to find a solution. The solution that was found covers the ground lease, which covers the more concerning of the securities that lost the regulatory treatment. In 2020, the Task Force will need to do some work on another subset of securities and this framework may serve as a template or at least a starting point to develop that solution. Mr. Fry thanked the industry and the SVO staff for working so productively on this effort.

David Persky (TIAA), representing the American Council of Life Insurers (ACLI) and interested parties, said the industry worked closely since last August to reach this compromise, noting that it works well for everyone and the industry look forward to implementing it. There are several deals in the marketplace right now and the market is eager to see the actual implementation of this change beginning Jan. 1, 2020.

Mr. Guerin made a motion, seconded by Ms. Walker to adopt this this P&P Manual amendment to add instructions for GLF transactions and make a referral to the Statutory Accounting Principles (E) Working Group so it can assess this definition for inclusion in the *Accounting Practices and Procedures Manual* (Attachment Three). The motion passed unanimously.

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5. Received and Exposed a Substantive Proposed P&P Manual Amendment to Remove the Financial Modeling Instruction for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designation and NAIC Designation Categories for These Securities

Mr. Fry said the next agenda item is a substantive proposed amendment to the P&P Manual to add instructions to remove the financial modeling instructions for residential mortgage-backed securities (RMBS)/CMBS and direct NAIC Investment Analysis Office (IAO) staff to produce NAIC designation and NAIC designation categories for these securities.

At the Summer National Meeting, the SVO staff discussed the idea that, at some point, the NAIC should align the RMBS/CMBS modeling to provide a single NAIC designation for modeled RMBS/CMBS. This would be a change from the current practice of providing a series of book/adjusted carrying value price breakpoints to companies to determine the NAIC designation. Staff raised this issue because of the upcoming implementation of NAIC designation categories for year-end 2020; i.e., the addition of 20 levels of credit risks instead of six. This will add a lot of complexity to create 19 breakpoints instead of the five current breakpoints that being used now, and might add expense and create some inconsistency across insurers reporting on these securities.

Mr. Fry said the IAO staff is recommending that the Task Force move to a single NAIC designation and NAIC designation category for the modeled assessment of credit risk for RMBS/CMBS to simplify NAIC and insurer processes, along with improving uniformity. The Task Force has discussed this a few times and it will be wise to expose this for a public comment period to get formal comments from the industry during a longer comment period. The SSG has offered to do some impact studies during the comment period that will give the Task Force additional insights.

Joshua Bean (Transamerica), representing the ACLI, said the industry appreciates the extended comment period and asked if it is possible to make it 75 days. The financial modeling process has been occurring for almost 10 years and there is a diversity of legitimate interest across this constituency to understand the new mappings. Mr. Fry said NAIC staff are recommending a 60-day public comment period to meet the year-end deadline.

Ms. Belfi made a motion, seconded by Ms. Rankin to receive and expose for a 60-day public comment period this P&P Manual amendment to remove the financial modeling instructions for RMBS/CMBS securities and move to the production of a single NAIC designation and NAIC designation categories for these securities and to make a referral to the Statutory Accounting Principles (E) Working Group, as this would impact SSAP No. 43R. The motion passed unanimously.

6. Heard an NAIC Staff Update on the Definition of "Principal Protected Securities"

Mr. Fry said SVO staff discussed during the Task Force's meeting at the Summer National Meeting an observation that certain classes of structured securities receive ratings that may not reflect a regulator's view of risk. The SVO advised the Task Force that it believes the credit rating providers are following their published methodologies for these investments but those methodologies, in staff's opinion, do not meet the NAIC's needs. The recommendation of the IAO directors was to exclude these investments from filing exemption and permit the SVO to review them using their methodologies, in this case most likely a look-through approach. On its Oct. 31 call, the Task Force directed the IAO staff to work with the industry on refining the definition that was exposed. The is a matter that may affect some insurers, so the Task Force is trying to accurately reflect the scope of securities. Mr. Fry asked Charles Therriault (NAIC) to provide an update on that work.

Mr. Therriault said the IAO staff met with industry representatives on calls held Dec. 3, Nov. 22, Nov. 15 and Nov. 8. There have been multiple versions of this definition exchanged to address each group's concerns. A general framework has evolved that identifies principal protected notes (PPNs) as a type of security that repackages one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s) that, if purchased by an insurance company on a stand-alone basis, would be eligible for filing exemption, but for which the underlying investments could generate potential returns in addition to the contractually promised cash flows paid according to a fixed schedule *or* the contractual interest rate paid by the PPN is zero or below market *and* the insurer would obtain a more favorable risk-based capital (RBC) charge or regulatory treatment for the PPN through filing exemption than it would were it to separately file the underlying investments in accordance with the policies in the P&P Manual.

Investments meeting these criteria would need to be filed with the SVO to determine if the security possesses any other non-payment risks that the SVO must assess under its Subscript S authority. There were a few noted exclusions, such as defeased or pre-refunded securities, and broadly syndicated securitizations. IAO staff believe this criteria hits upon the core issue—i.e. restructuring an investment to receive a more favorable RBC charge—and provides the SVO with discretion to review the transaction. At the industry's request, SVO staff is expanding the definition to include transaction examples. The goal of adding

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the examples is to provide additional clarity as to the regulatory concern and transactional structure that is a concern to the Task Force. Staff will bring this back to the Task Force for consideration in early 2020.

Mr. Fry said one of the principles is that a security—for example, a bond—usually has fixed cash flows. If a security promises additional returns in excess of those fixed cash flows, then that is a characteristic to identify that security. The second is that a lot of these are rated, and the rating agencies are rating these to achieve a below market return. The third principle—when looking underneath one of these securities—it just carries that same asset on a fixed income schedule, so it produces one set of RBC charges. It is questionable that those same securities can be packaged into a different structure to create a more favorable RBC charge, so on its surface, this causes some pause. Those are the three tenants that staff are looking at right now and are working with the industry to define. My Fry asked if there were any questions from the Task Force members or interested parties.

Ms. Becker said Kansas is supportive of this framework and approach, and that the Task Force is looking at this matter. She expressed appreciation for the effort and cooperation involved in coming to a consensus and helping ensure that this is moving forward appropriately and to making sure all of the regulatory issues are being addressed.

Mr. Spudeck said this is a fairly important issue for a lot of people on both sides of the aisle. He asked whether there is a target timeline for when there will be some physical documentation revised for people to look at and start digesting before the market starts creating the next generation.

Mr. Fry said he is open to suggestions and will continue working on this and finalize it early next year when the Task Force has a call, possibly as early as Feb. 15, 2020. He said he wants people to get a sense of what the Task Force is doing and asked Mr. Therriault when a draft could be ready for exposure.

Mr. Therriault said he would also expect a draft could be ready for the Task Force's first meeting in 2020. There has been extensive work already and a draft amendment is almost ready, but another iteration is needed. Ideally, he said he would like to have this ready for consideration at the Spring National Meeting.

Mr. Andersen (Andersen Insights) said he knows that a number of people have been working on this issue and commended them. Hopefully, as the discussions are open, some of the things that were mentioned will be considered but, most important, is how these assets meet the regulatory views of risk and meet the NAIC needs. His understanding of credit instruments, in general, is a question of credit because these are debt instrument and maybe are not as complicated as they may seem. There are three things Mr. Fry listed, one as promised returns that could exceed based returns, and it is true that an asset can be structured so that the returns that are reflected on the books and records of an insurer as one thing, and an asset may offer returns that are better than that. In his opinion, as long as the returns that are reported on a financial statement are minimal returns that are governed by the credit rating, he does not see how having excess returns is necessarily a problem. The question of what is the market rate of return can be a difficult and complicated thing for staff of a limited number to look at a broad number of deals and try to determine what a market rate of return is. Even if that is done, he is not sure what the question is. If an insurer elects to invest in an asset with a relatively lower return and reports that on its books and records, then the question of solvency and creditworthiness is addressed. The third point looking "underneath the hood" as to what the asset is, he said he believes everyone should support that, and it is possible with these structures to include assets that are prohibited assets. It is possible to include assets in these structures that will fill or overfill the basket. He said he believes that through structuring, it is possible to reduce risks—and the notion that there are building blocks and the building blocks result in the same risk additively as the structure itself is not necessarily always the case. He appreciates the fact that the Task Force is willing to have a discussion and open this up.

Mr. Bean said he appreciates Mr. Therriault's summary of the discussion thus far. It has been an excellent collaboration with a lot of different perspectives to cover. Ultimately, this has been successful in working toward truly defining in assessable terms what the actual analytical concern is and how it can be addressed in a manner that actually provides guidance and clear instruction to the filing entities and does not create unintended "scope creep." As Mr. Therriault has outlined, there is some work that we are continuing to do and hope that some of the examples will help illustrate further exactly what is meant to be targeted by this updated guidance, noting that it legitimately does present a risk profile that should be subjected to additional review at the hands of the SVO and the SSG and that is ultimately the core objective.

Mr. Fry said people should realize that what this would create is that these securities would not be able to use rating agencies ratings through the FE process. These securities will still be able to be filed with the SVO and will likely remain on the bond schedule; they may just get a different NAIC designation because the SVO will be using a different methodology.

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7. Received an IAO Staff Report on the Infrastructure Investment Study

Mr. Fry said NAIC staff earlier this year conducted a request for information on the U.S. insurance industry's infrastructure investments. He asked Nikki Hall (NAIC) to provide an update on this study.

Ms. Hall said the NAIC Center for Insurance Policy and Research (CIPR) and the NAIC Capital Markets Group—specifically, Michele Wong and Eric Kolchinsky—are collaborating on this study. The study will focus on infrastructure investment as an asset class and the insurance industry's participation in the infrastructure market, including barriers and opportunities.

The study was initiated in late August shortly after the Summer National Meeting with a request for information (RFI) to gather information and input from market participants and interested parties on key topics, such as the definition of infrastructure, the market size for infrastructure assets, the historical credit performance of infrastructure investments, and the treatment of infrastructure investments by state insurance regulators.

The first deadline for the RFI was in late September, where initial comments were requested on the definition of "infrastructure." Fourteen comment letters were received to this request and, after a thorough review and internal discussion, a proposed definition was drafted of "infrastructure," which was discussed during an Oct. 18 conference call with interested parties.

For the purposes of the study, it was decided the definition will focus on economic infrastructure, which is defined as "long-lived, capital intensive, large physical assets that provide essential services or facilities to a country, state, municipality, or region and contributes to its economic development or prosperity."

Some of the comments received suggested that social infrastructure should also be included in the definition; however, it was decided to exclude social infrastructure from the definition for now and do a separate analysis of social infrastructure at a later time.

Ms. Hall said the presentation, which includes the proposed definition, can be found on the CIPR website. The RFI document that was distributed in August is also available on the CIPR website.

The second deadline was Nov. 22, where a request was made for comments on the other components of the request for information, such as market size, credit performance and NAIC treatment of infrastructure. Seven comment letters have been received so far. While the comment deadline has passed, additional comments from interested parties can be submitted.

In regard to next steps for the study, the process of reviewing all the submissions received from the Nov 22 deadline has begun. The team is also following up with some that have submitted comments, and this work will continue over the next few weeks.

An issue brief is being drafted that will explain the rationale behind the proposed definition, which will be shared and posted to the NAIC website when final. Drafting of the full study will begin after that.

There are plans to hold another conference call before the 2020 Spring National Meeting to provide an update on the study drafting process.

8. Heard a Staff Update on Projects

Mr. Therriault provided updates on five projects:

- The integration of securities identifiers into the FE process. These two projects have both been deferred. The first component was the incorporation of the business entity cross-reference service (BECRS), which identifies the relationship between issuers and securities. The second component was the incorporation of the global identifier cross-reference service (GICRS) which would have added additional security identifiers. These two services can be implemented separately, but they are both complex. Given the other projects that are being worked on, coupled with the complexity of this data, the two projects had to be deferred.

- The next project is a status of the application of the Japan Credit Rating Agency, Ltd., to be a vendor of credit ratings to the NAIC. The securities rated by this credit ratings provider (CRP) require NAIC systems to have International Securities Identification Numbers (ISINs). Those identifiers are part of the GICRS data set, which is a project that is being deferred. Because of that dependency, this project is also being deferred.

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- Implementation of CRP data feeds for securities subject to the private rating letters component of filing exemption is also deferred for data feeds from Fitch Ratings, Morningstar and HR Ratings de Mexico. Priority was given to the carry-over procedure project and NAIC designation category project.

- Implement of the carry-over procedure in 2019 was released this month. This project implements the administrative symbols and process to extend an NAIC designation into the next filing year with a "YE" suffix and identify initial filing properly filed and self-designated with an "IF" suffix. The project also included the change over from administrative symbol NR (not rated) to ND (not designated) along with some operational improvements related to these processes and downstream reporting through AVS+.

- The effort to add NAIC designation categories into NAIC systems is on schedule for release in early 2020. This project will add the letter modifier to create NAIC designation categories for reporting at year-end 2020. This project was discussed in passing during the discussion on RMBS/CMBS modeling. NAIC designations will continue to be produced and reported, but this additional level of granular assessment of credit risk reporting will be available for insurer reporting for Dec. 31, 2020. There are no RBC factors associated with the NAIC designation categories, so there is no change to the RBC charges; however, this detail reporting of investment credit risk still has significant value when looking at an insurer portfolio.

9. Discussed Other Matters

Mr. Kolchinsky said the Capital Markets Group, working with the SSG, completed the collateralized loan obligation (CLO) stress test, or at least the initial batch of the CLO stress test. A special report was published Dec. 6 on the NAIC website, and an in-depth methodology for CLO stress testing was also published. He said he will be covering some of the results at the Financial Stability (EX) Task Force and will be contacting the states to talk about what was found.

Having no further business, the Valuation of Securities (E) Task Force adjourned.

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Draft: 2/27/2020

Valuation of Securities (E) Task Force
Conference Call
February 4, 2020

The Valuation of Securities (E) Task Force met via conference call February 4, 2020. The following Task Force members participated: Robert H. Muriel, Chair, represented by Kevin Fry (IL); Doug Ommen, Vice Chair, represented by Carrie Mears (IA); Lori K. Wing-Heier represented by Wally Thomas (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kathy Belfi (CT); David Altmaier represented by Ray Spudeck (FL); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary Anderson represented by John Turchi (MA); Al Redmer Jr. represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Bruce R. Ramge represented by Lindsay Crawford (NE); Marlene Caride represented by Diana Sherman (NJ); Linda A. Lacewell represented by Jim Everett (NY); Jessica K. Altman represented by Kimberly Rankin (PA); Kent Sullivan represented by Jamie Walker (TX); Todd E. Kiser represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA).

1. <u>Discussed an Amendment to Remove the Financial Modeling Instruction for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designations and NAIC Designation Categories for these Securities</u>

Mr. Fry said the first item on the agenda is to discuss the amendment to remove financial modeling instructions for residential mortgage-backed securities (RMBS)/commercial mortgage-backed securities (CMBS) securities. This amendment was received at the 2019 Fall National Meeting, where NAIC staff recommended moving to a single NAIC designation and NAIC designation category for the modeled assessment of credit risk for RMBS/CMBS to simplify NAIC and insurer operational processes, along with improving uniformity. The Task Force has discussed moving away from price-break points and towards determining a single NAIC designation. There have been some concerns expressed by industry that there will be significant adverse risk-based capital (RBC) consequences from making such a change now. Mr. Fry said that he has also had discussion with the Securities Valuation Office (SVO) and Structured Securities Group (SSG) staff, and they believe that they could produce a mapping process between the NAIC designations based upon the current price-break points and the NAIC designation categories until new RBC factors are adopted. Once those new RBC factors are adopted, additional price-break points would be needed. This does not prevent the Task Force from possibly eliminating price-break points in the future, but it should eliminate these immediate concerns. If Task Force members do not object, SVO staff are directed to draft a new amendment mapping the current NAIC designations derived from price-break points to an NAIC designation category and expose that amendment for a 30-day public comment period. There were no objections.

2. <u>Discussed an Amendment to the P&P Manual to Clarify That the Sovereign Rating Limitation Applies to FE</u>

Mr. Fry said the next item is to discuss a proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to clarify that the sovereign rating limitation applies to filing exemption (FE). He said this amendment was exposed during the Task Force's Oct. 31, 2019, conference call. This change was proposed because the current limitation could be interpreted to mean that only NAIC designations assigned by the SVO (as opposed to those produced through the FE process) are capped at the NAIC Foreign Sovereign Designation Equivalent List. The amendment addressed that potential interpretation inconsistency by clarifying that all NAIC designations for foreign securities will be capped according to the NAIC Foreign Sovereign Designation Equivalent List published on the SVO's web page.

Mr. Fry said that industry has expressed to him that that there can be legitimate reasons why a rating should be allowed to be higher than the sovereign rating and that limiting it may negatively affect them. The SVO mentioned that the methodologies permitting sovereign rating exceptions can vary greatly. Mr. Fry asked Charles A. Therriault (NAIC) if his staff could look at developing criteria for an acceptable sovereign rating exception methodology Mr. Therriault said the SVO staff could review sovereign rating exception methodologies and propose an updated amendment to the P&P Manual. A few of the possible criteria could include: 1) assets of the issuer located outside of the domicile of the issuer; 2) collateral or other structural protections; 3) lockbox and escrow payment provisions; and 4) parent company or ownership interests of the issuer located outside of the domicile of the issuer.

Draft Pending Adoption

John Petchler (Conning representing the Private Placement Investors Association—PPiA) thanked the Task Force for listening to the PPiA's comments and said that they looked forward to working constructively on this issue. Eric Hovey (Payden & Rygel) said they appreciate the opportunity to comment on this issue and that they also look forward to working with the SVO.

Mr. Fry directed SVO staff to work on updating the proposal.

3. Exposed an Updated Amendment to the P&P Manual to Update the Definition and Instructions for PPNs

Mr. Fry said his agenda item was discussed at the 2019 Summer National Meeting, where their observation was that certain classes of structured securities received ratings that may not reflect a state insurance regulator's view of the risk. An amendment was exposed that would effectively take securities that were defined as principal protected notes (PPNs) out of the FE space, and they would need to be filed with the SVO. Comments were received on that proposal, and it became clear that the scope of the definition would need to be refined to cover just this class of securities. The Task Force directed the SVO staff to work with the American Council of Life Insurers (ACLI) and others to develop this refined definition of a PPNs. Mr. Fry asked Mr. Therriault to review that update.

Mr. Therriault said there were many conversations with the industry working group along with multiple versions of the definition. The resulting product in this updated amendment reflects that collaboration. The amendment needed to be expanded beyond just a simple definition and into a full new section of the P&P Manual. The definition framework described at the 2019 Fall National Meeting is still consistent. The identifying characteristics of a PPN is a type of security that repackages one or more underlying investments and for which contractually promised payments according to a fixed schedule (principal and, if applicable, interest, make whole payments and fees thereon) are satisfied by proceeds from an underlying bond(s) that, if purchased by an insurance company on a stand-alone basis, would be eligible for FE, but for which the repackaged security structure enables potential returns from the underlying investments in addition to the contractually promised cash flows paid to such repackaged security according to a fixed schedule; or the contractual interest rate paid by the PPN is zero, below market or, in any case, equal to or below the comparable risk-free rate. Given those two provisions, the insurer would also obtain a more favorable RBC charge or regulatory treatment for the PPN through FE than it would were it to separately file the underlying investments in accordance with the policies in the P&P Manual.

Mr. Therriault said this criteria really focuses on the core regulatory issue and identifies these other non-payment risks. Assessing the other non-payment risk aspects, which the SVO believes these securities possess, is a function uniquely assigned to the SVO for evaluation under its Subscript S identification authority. The restructuring an investment to receive a more favorable RBC treatment is really the core issue. Industry requested that examples be include in the definition. Some have been added, but they do not encompass all variants. Mr. Therriault recommended exposing this update for a 30-day public comment period.

Ms. Becker (KS) said that she would like more information on the proposed timeline for this. If exposed today for a 30-day public comment period, how will the Task Force anticipate it will move forward from that point? Mr. Fry explained that the Task Force process of exposing for 30 days would permit it to go over all the comment letters and consider the amendment at the Spring National Meeting.

Josh Bean (Aegon, representing the ACLI) said that the ACLI supports the exposure and that it was difficult to come up with a mosaic that captures all potential items in the definition. By working together and not letting perfect get in the way of the good, an appropriate level of guidance was able to be drafted and support this exposure.

Michelle Werner (American International Group—AIG) said she participated on the proposed definition. She said it was a great coordinated team approach and resulted in a definition that provides more clarity around the specific structure that the SVO was concerned about. This would permit the SVO to review these investments and allow for further evaluation of them. She asked about having an opportunity to collaborate with them on a methodology that ensures the risks, structures and the cash flow are appropriately analyzed. The goal is to achieve the least amount of market disruption as possible by working together to develop a meaningful methodology that clearly addresses the risk. She said she was concerned that the wrong

Draft Pending Adoption

methodology could make these investments prohibitively expensive and, therefore, uneconomical if the risk factors as identified by the SVO are not analyzed with the appropriate methodology.

Mr. Fry said it is worth pointing out that these securities will still likely be classified as bonds even after the SVO review. The methodology may lower the designation, but the securities is not be removed from schedule D. As far as looking at the methodology, Mr. Fry asked Mr. Therriault to comment.

Mr. Therriault said if you look at the P&P Manual, there is very little, if any, prescriptive or formulaic methodologies, as being requested, for any of the SVO's analytic work. It is intentional that the Task Force has empowered the SVO to have wide analytical discretion on the securities it reviews, and the SVO requests the Task Force continue granting that discretion for these securities too. Analytical discretion is very necessary for the SVO in reviewing these transactions given the wide variety of structures and the nature of these risks.

Mr. Nablach (Security Benefit) said that the new definition of PPN explicitly includes scoping in collateralized loan obligation (CLO) combination notes. The inclusion of CLO combination notes may have been influenced by a report published in December 2019 by the Capital Markets Bureau (CMB) relating to CLOs and stress tests. Security Benefit and other market participants have serious concerns related to the methodology and analytical outcomes of this stress test, specifically, but no limited to:

- The methodology which by defaults are measured.
- The results failed to include post global financial crisis data, including loan losses, as well as structural changes that have been made to CLOs and changes that have been made to the investment guidelines governing the assets of CLOs, which made them a lot more robust prior to the global financial crisis.
- The stress recovery assumptions that were used in the analysis.
- The lack of clarity or insight on how losses on CLO notes were derived.

Mr. Nablach suggested that the Task Force engage an independent expert to conduct, factually and analytically correct, analysis on the asset class. There is good precedence for engaging an independent expert to resolve factual differences, and this independent study is something that should take a fairly limited amount of time and result in the best outcome for the NAIC and industry participants.

Eric Kolchinsky (NAIC) said that research was recently published with some of these concerns and that he can discuss any of these points. He said he looks forward to any comment submissions that may occur as part of this process and respond to them in the context of a regulatory perspective versus somebody who is a holder of an equity piece who will analyze them. He said he does not believe there is a need for an independent expert. These combination notes have been looked at for a long time, and this research was merely something that could bolster a case. These securities are not being prohibited; they are merely being looked at in a way that is consistent with other products. Mr. Kolchinsky said he looks forward to receiving the written comments and will prepare a response to them.

Mr. Therriault said his recollection of the research that was done from the Capital Markets Bureau, CLOs as an asset class, was affirmed as performing quite well. It was really the restructuring of CLOs into a CLO combination note, which is a completely different structure, that was actually identified as a problem. He said that the PPN recommendation before the Task Force is on the repackaged investment, the CLO combination note, that is a completely different security from a CLO.

Mr. Kolchinsky said they did find that CLOs, as an asset class, especially where most insurance invested—at the top of the capital structure—were extremely robust. They found that the CLO combination notes, which rely on a large portion of the principal return to the equity or residual portion of CLO, were sensitive to default assumptions, and if things did not go very well, the result is a large loss.

Mr. Fry directed SVO staff to expose this item for 30-day public comment period ending Mar. 5, 2020.

4. <u>Adopted a P&P Manual Amendment to Reflect the U.S. SEC's Adoption of a New Rule to Modernize Regulation of ETFs</u>

Draft Pending Adoption

Mr. Fry said item four on the agenda is a P&P Manual amendment to reflect the U.S. Securities and Exchange Commission's (SEC's) adoption of a new rule to modernize regulation of exchange-traded funds (ETFs). At the 2019 Fall National Meeting, the SVO proposed a non-substantive P&P Manual amendment to reflect updates adopted by this. He asked Marc Perlman (NAIC) to give a brief update on this change and the proposed amendment to incorporate this change in the P&P manual.

Mr. Perlman said the rule became effective Dec. 23, 2019, and as discussed at the Fall National Meeting, the rule permit ETFs, that satisfy certain conditions, to operate without first obtaining an exemptive order from the SEC under the Investment Company Act of 1940 (the "Act"). The SEC has stated that the intent of the rule is to modernize the regulatory framework for ETFs by reducing expenses and delays in creating new ETFs, promoting greater consistency, transparency and efficiency for ETFs and facilitating greater competition among ETFs.

ETFs contain certain features that distinguish them from the types of investment companies originally contemplated by the Act and its rules and, therefore, have needed to rely on SEC exemptive orders to operate as investment companies under the Act. The new rule will end the need for most exemptive relief. Additionally, the rule permits ETFs to use "custom baskets," which do not reflect a pro rata representation or representative sampling of the ETF's portfolio holdings, and the SEC is rescinding current ETF marketing restrictions.

In order to rely on the new rule, an ETF must satisfy a new definition of ETF and various conditions including: 1) updated website disclosures (such as historical net asset value [NAV], premium and discount, and bid-ask spread information) and adoption of policies and procedures that govern the construction and acceptance of baskets. The new rule will rescind the exemptive orders from existing ETFs, which will be able to rely on the rule going forward. However, certain categories of ETF will not be covered by the rule.

The SVO takes the position that since the new rule primarily affects SEC exemptive relief and ETF reporting and disclosure, it will not affect the quantitative and qualitative factors the SVO considers when analyzing ETFs. As such, the SVO recommends non-substantive P&P Manual amendments to remove references to SEC exemptive orders from descriptions of ETFs and clarification that Regulatory Treatment Analysis Service (RTAS) application filers only need to provide SEC exemptive orders to the SVO to the extent they are applicable.

Mr. Bean said the ACLI does not have any concerns with these updates to align the P&P Manual terminology with SEC guidance.

Mr. Thomas made a motion, seconded by Ms. Cross, to adopt the P&P Manual amendment to remove references to SEC exemptive orders from descriptions of ETFs and clarification that Regulatory Treatment Analysis Service (or RTAS) application filers only need to provide SEC exemptive orders to the SVO to the extent they are applicable. The motion passed unanimously.

5. <u>Discussed Other Matters</u>

Mr. Therriault said it has come to the SVO's attention that there has been some confusion regarding the new NAIC Fixed Income-Like SEC Registered Funds List. Funds on this list are permitted to be reported on the common stock schedule, Schedule D-2, Part 2, with an NAIC designation. The SVO did not have any funds on this list as of Dec. 31, 2019, so there are no funds to report on the common stock schedule with an NAIC designation for year-end 2019. This list is maintained similarly to the ETF list. The SVO will add the fund's security ID to the list on the SVO's web page after it has been reviewed. Insurers must still file the fund it owns in VISION so that it is reviewed by the SVO for the current year. After the security has been reviewed, the SVO assigns it an NAIC designation, which is then published in AVS+. The SVO does not publish NAIC designations on its web page on the fund lists, only AVS+. Again, there were no funds on this list for 2019, so there is nothing for insurers to report for 2019. Some vendors made this a required field in their systems; it only needs to be reported if an NAIC designation was assigned to the fund and published in AVS+.

Mr. Fry said having no further business, the Valuation of Securities (E) Task Force adjourned.

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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)

CC: Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)
Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Updated Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Include Instructions for Financial Modeled RMBS/CMBS Securities to Map NAIC Designations to NAIC Designations Categories

DATE: February 10, 2020

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1. Summary – On the Feb. 4, 2020 interim meeting of the Valuation of Securities (E) Task Force NAIC staff were directed to draft and expose a P&P Manual amendment retaining the Financial Modeling and book/adjusted carrying value price ranges for modeled RMBS/CMBS securities but add mapping instructions from the resulting NAIC Designation to produce an NAIC Designation Category so that insurers can report an NAIC Designation Category. This mapping from an NAIC Designation to the NAIC Designation Category midpoint would be a temporary measure until new Risk Based Capital factors are adopted for each NAIC Designation Category and new price ranges can be developed. As requested by the Task Force, there would be no regulatory capital impact from this proposed change.

2. Recommendation – The IAO staff recommend these updated instructions be adopted by the Task Force to provide insures and their system vendors guidance for year-end. It also recommends referring this amendment, if adopted, to the Statutory Accounting Principles (E) Working Group to inform them that there would be no change to SSAP 43R **-** Loan-Backed and Structured Securities, at this time.

3. Proposed Amendment – The following text shows the revisions needed in Part Four with edits in red-underline.

PART FOUR
THE NAIC STRUCTURED SECURITIES GROUP

27. The NAIC Designation and NAIC Designation Category for a given modeled RMBS or CMBS CUSIP owned by a given insurance company depends on the insurer's book/adjusted carrying value of each RMBS or CMBS, whether that carrying value, in accordance with *SSAP No. 43R—Loan-Backed and Structured Securities*, paragraphs 25 through 26a, is the amortized cost or fair value, and where the book/adjusted carrying value matches the price ranges provided in the model output for each NAIC Designation and the mapped NAIC Designation Category, reflected in the table below, to be used for reporting an NAIC Designation Category until new Risk Based Capital factors are adopted for each NAIC Designation Category and new prices ranges developed; except that an RMBS or CMBS tranche that has no expected loss under any of the selected modeling scenarios and that would be equivalent to an **NAIC 1** Designation **and NAIC 1.D Designation Category** if the filing exempt process were used, would be assigned an **NAIC 1** Designation **and NAIC 1.D Designation Category** regardless of the insurer's book/adjusted carrying value.

NOTE: Please refer to the detailed instructions provided in SSAP No. 43R.

NAIC Designation Determined by Modeled Price Ranges	Mapped NAIC Designation Category
1	1.D
2	2.B
3	3.B
4	4.B
5	5.B
6	6

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Mike Monahan
Senior Director, Accounting

Tracey Lindsey
President

March 11, 2020

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Ms. Carrie Mears, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64016-2197

Re: Updated Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Include Instructions for Financial Modeled RMBS/CMBS Securities to Map NAIC Designations to NAIC Designations Categories

Dear Mr. Fry and Ms. Mears:

ACLI[1] and NASVA[2] ("the undersigned") appreciate the opportunity to provide comments on the above referenced proposal to the Valuation of Securities Task Force ("the Task Force").

We appreciate the ongoing collaboration with the NAIC Investment Analysis Office ("IAO"), in particular their efforts to reduce the complexity of the transition to greater granularity in the depiction of credit risk within statutory filings (i.e., the move to twenty NAIC designation categories). The undersigned generally support the proposed interim approach, as drafted, for mapping NAIC Designations to NAIC Designation Categories until such time as more granular risk-based capital factors are approved and become available for incorporation into the existing breakpoint methodology for modeled RMBS/CMBS securities. However, we respectfully request that the Task Force give further consideration to the appropriate mapping of bonds with no expected loss under any modeling scenario ("zero-loss bonds").

Given that the modeling methodology includes a severe stress scenario, we believe that the NAIC 1.A Designation Category is a more accurate depiction of the credit risk inherent to zero loss bonds than that

[1] The ***American Council of Life Insurers*** (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States. Learn more at www.acli.com.

[2] The ***North American Securities Valuation Association*** (NASVA) is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes.

implied by mapping such bonds to the NAIC 1.D Designation Category, as currently proposed. Under current guidance, the credit risk on zero loss bonds is appropriately depicted as equivalent to the highest grade of corporate credits. To date, we are not aware of any formal discussion or proposal outlining perceived merits of a change to equate the expected losses on zero loss bonds with the credit risk of AA-rated corporate credits, and have not seen empirical performance data supporting such a change in presumption.

The undersigned understand that the proposed interim solution will have no immediate Risk-Based Capital ("RBC") impact. However, we are concerned that mechanically mapping zero loss bonds to anything other than the NAIC 1.A Designation Category at this time, even if only inadvertently, may establish a de facto presumption which could unduly influence future discussions at NAIC Committees.

We respectfully request that no changes to the existing presumptions regarding expected losses on zero loss bonds be implemented prior to allowing the Task Force, as well as the Investment Risk-Based Capital Working Group, adequate time to more fully deliberate on the conceptual merits and practical implications of any such changes. We feel that maintaining the standard of mapping zero loss securities to the highest NAIC Designation (and NAIC Designation Category) better reflects the classification standard likely to emerge as the most rational depiction of risk as the new RBC factors are adopted and implemented – which will help both regulators and industry maintain more precise expectations regarding the impact of the RBC factor updates. ACLI and NASVA member companies are grateful for this opportunity to collaborate with the SVO to ensure a smooth transition to the new NAIC Designation Category framework.

Please do not hesitate to contact us should you have any questions. Thank you.

Sincerely,

Senior Director, Accounting Policy
American Council of Life Insurers

Tracey Lindsey
President
North American Securities Valuation Association

cc: Mr. Charles Therriault, Director, SVO
Mr. Marc Perlman, Investment Counsel

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)

CC: Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)
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 Remove the Financial Modeling Instructions for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designation and NAIC Designations Categories for these Securities

DATE: September 30, 2019

1. **Summary** – On Oct. 11, 2018, the Valuation of Securities (E) Task Force adopted an amendment to delete the Modified Filing Exempt (MFE) provisions from the P&P Manual and directed a referral to the Statutory Accounting Principles (E) Working Group recommending the deletion of the MFE provisions from Statement of Statutory Accounting Principles (SSAP) No. 43R—Loan-Backed and Structured Securities. The effect of these changes resulted in these securities coming under the filing exempt instructions in the P&P Manual, if they have an Eligible NAIC CRP Credit Rating assigned to them. This change eliminated using the book adjusted carrying value to determine the NAIC designation for these securities.

The IAO staff reported to the Task Force at the Summer National Meeting that at some point the NAIC should align the RMBS/CMBS modeling to provide a single NAIC Designation for modeled RMBS/CMBS. This would be a change from the current practice of providing a series of book adjusted carrying value price breakpoints to companies to determine the NAIC designation. Staff also reported that with the upcoming implementation of NAIC designation categories, the new 20 additional granular delineations of credit risk, the complexity and expense to the NAIC and insurers to produce and incorporate the needed19 price breakpoints would be high.

2. **Recommendation** – The IAO staff recommends that the NAIC move to a single NAIC designation and NAIC designation category modelled assessment of credit risk for RMBS/CMBS. This is a good time to make such a change prior to the NAIC and insurance companies making modifications to their systems for the NAIC designation categories. Such a change will produce a uniform and consistent credit risk assessment for these securities permitting insures to report the same SSG determined NAIC designation. Given the impact of this change to SSAP 43R - Loan-Backed and Structured Securities, staff recommends a referral to the Statutory Accounting Principles (E) Working Group for a simultaneous exposure.

3. **Proposed Amendment** – The following text shows the revisions in Part Four that would appear in the 2019 P&P Manual format.

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PART FOUR
THE NAIC STRUCTURED SECURITIES GROUP

DEFINITIONS

1. The following terms used in this Part Four have the meaning ascribed to them below.

   - **ABS** stands for asset-backed securities and means structured securities backed by consumer obligations originated in the United States.
   - **CMBS** stands for commercial mortgage-backed securities and means structured securities backed by commercial real estate mortgage loans originated in the United States. The definition of CMBS may refer to securitizations backed by commercial mortgages, respectively, originated outside of the Unites States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: (a) has the necessary information about the commercial mortgage and commercial mortgage loans originated outside of the United States to fully model the resulting securities; and (b) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.
   - **Initial Information** means the documentation required to be filed with an Initial Filing of an RMBS or a CMBS CUSIP, pursuant to the section below and pertaining to Loan Information, Reps and Warranty Information and Structure and Formation Information for the transaction, where:
     - *Loan Information* means a review of the loan files by a third party to assess the sufficiency of legal title and other related issues.
     - *Reps and Warranty Information* means the actual representation and warranties in effect for the securitization given by the mortgage originator(s) to the Trust pertaining to loan origination processes and standards, compliance with applicable law, loan documentation and the process governing put backs of defective mortgages back to the originator(s).
     - *Structure and Formation Information* means the waterfall, as described in the definition of Ongoing Information, information and documentation in the form of legal opinions and documentation governing the formation of the securitization and its entities relative to issues such as bankruptcy remoteness, true sale characterization, the legal standards and procedures governing the securitization and other similar issues.
   - **Legacy Security**, for the purposes of this section shall mean any RMBS and any CMBS that closed prior to January 1, 2013.
   -

- **Ongoing Information** consists of: (a) tranche level data; such as principal balance, factors, principal and interest due and paid, interest shortfalls, allocated realized losses, appraisal reductions and other similar information for the specific tranche; (b) trust level data, such as aggregate interest and principal and other payments received, balances and payments to non-trance accounts, aggregate pool performance data and other similar information; (c) loan level performance information; and (d) a computerized model of rules that govern the order and priority of the distribution of cash from the collateral pool (i.e., the "waterfall") to the holders of the certificates/securities—provided in the format and modeling package used by the NAIC financial modeling vendor.
- **Original Source**, with respect to a specific set of data, means the Trustee, Servicer or similar entity that is contractually obligated under the agreement governing the RMBS or CMBS to generate and maintain the relevant data and information in accordance with standards specified in applicable agreements or an authorized re-distributor of the same.
- **Re-REMIC** is a securitization backed by: (a) otherwise eligible RMBS from one or two transactions; or (b) otherwise eligible CMBS from one or two transactions at closing. Re-REMICs cannot acquire any Underlying Securities after closing.

- **RMBS** stands for residential mortgage-backed securities and means structured securities backed by non-agency residential mortgages originated in the United States, where the collateral consists of loans pertaining to non-multi-family homes. That includes prime, subprime and Alt-A mortgages, as well as home-equity loans, home-equity lines of credit and Re-REMICs of the above. Excluded from this definition is agency RMBS, where the mortgages are guaranteed by federal and federally sponsored agencies such as the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC) and loans against manufactured or mobile homes or collateralized debt obligations backed by RMBS. The exclusion covers bonds issued and guaranteed by, or only guaranteed by, the respective agency. Also not included are loans guaranteed by the U.S. Department of Veteran Affairs or the U.S. Department of Agriculture's Rural Development Housing and Community Facilities Programs. The definition of RMBS may refer to securitizations backed by residential mortgages, respectively, originated outside of the Unites States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: (a) has the necessary information about the residential mortgage and residential mortgage loans originated outside of the United States to fully model the resulting securities; and (b) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.
- **Underlying Security** means the RMBS or CMBS backing a Re-REMIC. A Re-REMIC cannot be an Underlying Security.

NOTE: The definitions of RMBS and CMBS reflect limitations associated with the financial modeling process, NAIC credit rating provider (CRP) internal naming conventions and SSG processes, as more fully discussed below and may, therefore, be subject to a narrower or a broader reading in any reporting period. Please call the SSG with any concerns or questions about the scope of the definitions for a given reporting period. Also note:

- It is possible that the scope of the RMBS and CMBS definitions may be broadened because the financial modeling vendors indicate other collateral or waterfall structures can be modeled.

- NAIC CRPs may adopt different internal conventions with respect to what market or asset segments are within their rated populations of RMBS, CMBS or ABS. This could affect the application of the adopted NAIC methodology or require the NAIC to select which naming process it wishes to adopt.
- It is possible that the SSG will acquire analytical assessment capabilities that permit the assessment of existing, additional or different structured securities that cannot now be modeled or that are not currently rated.

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Certain Administrative Symbols

2. The following SVO Administrative symbols are used in the Valuation of Securities (VOS) Products to identify RMBS and CMBS that the NAIC vendor has confirmed will be subject to the financial modeling methodology described in this Part.

- **FMR** – Indicates that the specific CUSIP identifies an RMBS that is subject to the financial modeling methodology.
- **FMC** – Indicates that the specific CUSIP identifies a CMBS that is subject to the financial modeling methodology.

The use of these SVO Administrative symbols in the VOS Product and published in the AVS+ Products compiled by the SVO and SSG as the SVO List of Investment Securities means the insurer should not use the filing exempt process for the security so identified.

NOTE: The administrative symbols **FMR** and **FMC** are related to symbols that insurers are required to use in the financial statement reporting process.

Quarterly Reporting of RMBS and CMBS

3. To determine the NAIC Designation to be used for quarterly financial statement reporting for an RMBS or CMBS purchased subsequent to the annual surveillance described in this Part, the insurer uses the prior year-end assigned NAIC Designation and NAIC Designation Category for that CUSIP (which can be obtained from the NAIC)in accordance with, *SSAP No. 43R—Loan-Backed and Structured Securities*

Limited Filing Exemption for RMBS and CMBS

4. **RMBS and CMBS that can be Financially Modeled** – RMBS and CMBS that can be financially modeled are exempt from filing with the SVO. NAIC Designations and NAIC Designation Categories for RMBS and CMBS that can be financially modeled are assigned by SSG, not by the use of credit ratings of CRPs.

5. RMBS and CMBS securities that cannot be Financially Modeled

   - **But Are Rated by a CRP** – RMBS and CMBS that cannot be financially modeled but that are rated by a CRP are exempt from filing with the SSG. The NAIC Designations and NAIC Designation Categories for these RMBS and CMBS are determined by application of the filing exemption procedures discussed in this Manual.
   - **But Are Not Rated by a CRP** – RMBS and CMBS that cannot be financially modeled and that are not rated by a CRP are not filing exempt and must be filed with the SSG or follow the procedures, as discussed below in this Part.

Filing Exemption for ABS

6. ABS rated by a CRP are exempt from filing with the SSG.

Review of Decisions of the SSG

7. Analytical decisions made through the application of financial modeling are not subject to the appeal process. In the absence of an appeal, the SSG shall provide whatever clarification as to the results of financial modeling is possible to any insurer who requests it and owns the security, provided that it is not unduly burdensome for the SSG to do so. Any decision made by the SSG that results in the assignment of an NAIC Designation (including NAIC Designation Categories) and does not involve financial modeling methodology, whether developed by the SSG on its own or in collaboration with the SVO, is subject to the appeal process.

8. The policy statement set forth in this section shall be applicable generally to any transaction filed with the SSG for an analytical assessment and assignment of an NAIC Designations and NAIC Designation Categories. Any filing with the SSG is deemed to be incomplete unless the insurer has provided the information, documentation, and data in quantity and quality sufficient to permit the SSG to conduct an analysis of the creditworthiness of the issuer and the terms of the security to determine the requested analytical value. It is the obligation of the reporting insurance company to provide the SSG with all necessary information. It is the responsibility of the SSG to determine whether the information provided is sufficient and reliable for its purposes and to communicate informational deficiencies to the reporting insurance company.

Documentation Standards

9. In order for an insurer-owned RMBS or CMBS to be eligible for the year-end modeling process, conducted pursuant to this section below, the analysis must be based on information, documentation and data of the utmost integrity. A Legacy Security must meet the Ongoing Information requirements. An RMBS, CMBS or Re-REMIC that is not a Legacy Security must meet the Initial Information and Ongoing Information requirements. For the purposes of determining a Re-REMIC's status as a Legacy Security, the closing date of the Re-REMIC (not the Underlying Security) shall be used. The SSG may, in its sole discretion, determine that the Initial Information and/or Ongoing Information is not sufficient and/or not reliable to permit the RMBS or CMBS CUSIP to be eligible for financial modeling. If the SSG determines that the Initial Information and/or Ongoing Information is not sufficient and/or not reliable to permit the RMBS or CMBS CUSIP to be eligible for financial modeling, it will communicate this decision to the insurer and invite a dialogue to ascertain whether alternative information is available that would be deemed sufficient and/or reliable by the SSG.

Initial Information Requirements

10. An RMBS or CMBS meets the Initial Information Requirements if the security meets one of the following three conditions:

- **RTAS** – The RMBS or CMBS was assigned a preliminary price grid or designation as described in this Part;
- **Initial Sufficiency Filing** – The RMBS or CMBS was reviewed by SSG through an Initial Sufficiency Filing; or

- **Safe Harbor** – The RMBS or CMBS meets the Safe Harbor requirements.

Initial Sufficiency Information Filing

11. An insurance company may file Initial Sufficiency Information with the SSG for the purpose of obtaining a determination that an RMBS or CMBS CUSIP is eligible for financial modeling under the annual surveillance process discussed below. Initial Sufficiency Information is only filed once for any given RMBS or CMBS. Reporting insurance companies are solely responsible for providing the SSG with Initial Information. A determination by the SSG that a given RMBS or CMBS CUSIP is eligible for financial modeling after an Initial Sufficiency Filing assessment is subject to the further and continuing obligation that the SSG obtain or the insurer provide the SSG with updated Ongoing Information close to the date of the annual surveillance.

12. **Required Documents for Initial Sufficiency Filing** – An insurer that owns an RMBS or a CMBS for which Initial Information is not publicly available shall provide the SSG with the following documentation.

13. **RMBS** – Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for an RMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:

    - Pooling and Servicing Agreement or similar
    - Prospectus, Offering Memorandum or similar; Accountant's comfort letter
    - If applicable, ISDA Schedules and Confirmations or similar
    - Legal opinions given in connection with the transaction
    - Any other documents referenced by the above
    - Third-Party Due diligence scope document and raw results. If less than 100% due diligence, detailed description of the loan selection process
    - If applicable, loan purchase agreements or similar. Loan Tape

14. **CMBS** – Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for a CMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:

    - Pooling and Servicing Agreement or similar
    - Prospectus, Offering Memorandum or similar; Accountant's comfort letter
    - If applicable, ISDA Schedules and Confirmations or similar

- Legal opinion given in connection with the transaction
- Any other documents referenced in the above
- Asset Summaries
- Loan Tape
- Loan documents, including reliable information about the terms of the transaction; including, but not limited to, financial covenants, events of default, legal remedies and other information about financial, contractual or legal aspects of the transaction in form and substance consistent with industry best practices for CMBS issuance.
- In certain cases, additional documents below will enable the SSG to verify and validate initial underwriting information of the property securing the CMBS. These documents may be required in form and substance consistent with best practices for typical CMBS issuance.
- Historical operating statements and borrower's budget
- Underwriter's analysis of stabilized cash flow with footnotes of assumptions used
- Property type specific, rent roll information
- Appraisals and other data from recognized industry market sources
- Independent engineering report (Property Condition Assessment)
- Environmental Site Assessment (ESA) – Phase I/Phase II
- Documentation related to seismic, flood and windstorm risks
- Franchise agreements and ground leases, if applicable
- Management agreements

SSG Modeling Alerts

15. The SSG shall at all times have discretion to determine that differences in the structure, governing law, waterfall structure or any other aspect of a securitization or a class of securitization requires that insurance companies provide Initial Information and/or Ongoing Information additional to or different from that identified in this Part. The SSG shall communicate such additional or different documentation requirements to insurers by publishing a Modeling Alert on the NAIC website and scheduling a meeting of the VOS/TF to ensure public dissemination of the decision.

Safe Harbor

16. Safe Harbor options serve as proxies for the Initial Sufficiency filing. The options reflect publicly available information that a third party has analyzed the Initial Information. Because the structured securities market is quite dynamic, the list of Safe Harbor options may change frequently, with notice and opportunity for comment, as described in this section. An RMBS or CMBS meets the Initial Information requirement if:

- At least two Section 17(g)-7 reports issued by different CRPs are publicly available; or
- A security that is publicly registered under the federal Securities Act of 1933.

Ongoing Information Requirements

17. An RMBS or CMBS meets the Ongoing Information Requirements if Ongoing Information is available to the SSG and the relevant third-party vendor from an Original Source. The SSG, in its sole discretion and in consultation with the relevant third-party vendor, may determine that the Ongoing Information is not sufficient or reliable to permit a given RMBS or CMBS CUSIP to be financially modeled. However, in making such a determination, the SSG shall take into account reasonable market practices and standards.

Special Rules for Certain Re-REMICs

18. Re-REMICs are generally simple restructurings of RMBS or CMBS. An Initial Sufficiency Filing for a Re-REMIC (a) which is not a Legacy Security itself but (b) where each Underlying Security is a Legacy Security shall not require submission of information regarding the Underlying Securities. In most cases, a prospectus for the Re-REMIC will be sufficient. If the SSG determines that additional information about the Re-REMIC structure or formation is required, it will communicate this decision to the insurer and invite a dialogue to ascertain whether additional information is available that would be deemed sufficient by the SSG.

Annual Surveillance of RMBS and CMBS – Modeled and Non-Modeled Securities

Scope

19. This section explains the financial modeling methodology applicable to RMBS and CMBS (defined above) securitizations applicable to modeled securities subject to *SSAP No. 43R—Loan-Backed and Structured Securities*. Please refer to SSAP No. 43R for a description of securities subject to its provisions. The VOS/TF does not formulate policy or administrative procedures for statutory accounting guidance. Reporting insurance companies are responsible for determining whether a security is subject to SSAP No. 43R and applying the appropriate guidance.

Important Limitation on the Definitions of RMBS and CMBS

20. The definitions of RMBS and CMBS above are intended solely to permit the SSG to communicate with financial modeling vendors, insurance company investors who own RMBS and CMBS subject to financial modeling and their investment advisors to facilitate the performance by the SSG of the financial modeling methodology described below. The definitions contained in this section are not intended for use and should not be used as accounting or statutory statement reporting instructions or guidance.

    NOTE: Please refer to *SSAP No. 43R—Loan-Backed and Structured Securities* for applicable accounting guidance and reporting instructions.

Analytical Procedures Applicable to RMBS and CMBS Securitizations Subject to Financial Modeling Methodology

Filing Exemption Status of RMBS and CMBS

21. RMBS and CMBS are not eligible for the filing exemption because credit ratings of CRPs are no longer used to set risk-based capital (RBC) for RMBS or CMBS. However, RMBS and CMBS are not submitted to the SSG.

Use of Financial Modeling for Year-End Reporting for RMBS and CMBS

22. Beginning with year-end 2020 for RMBS and CMBS, NAIC Designations and NAIC Designation Categories will be assigned by SSG utilizing the NAIC-selected vendor's financial model output with defined analytical inputs selected by the SSG. The vendor will provide the SSG with a risk profile for each RMBS or CMBS sufficient for SSG to assess the credit risk of these securities and assign an NAIC Designation and NAIC Designation Category.

NOTE: Please refer to *SSAP No. 43R—Loan-Backed and Structured Securities* for guidance on all accounting and related reporting issues.

Analytical Procedures for RMBS and CMBS

23. The SSG shall develop and implement all necessary processes to coordinate the engagement by the NAIC of a vendor who will perform loan-level analysis of insurer-owned RMBS and CMBS using the vendor's proprietary models.

RMBS and CMBS Subject to Financial Modeling

Setting Microeconomic Assumptions and Stress Scenarios

24. Not later than September of each year, the SSG shall begin working with the vendor to identify the assumptions, stress scenarios and probabilities (hereafter model criteria) the SSG intends to use at year-end to run the vendor's financial model.

The Financial Modeling Process

25. Information about the financial modeling process can be found at *www.naic.org/structured_securities/index_structured_securities.htm*.

Cashflow and Expected Losses for Financially Modeled RMBS and CMBS

26. For each modeled RMBS and CMBS, the financial model determines the net present value in a number of macro-economic scenarios. SSG then maps the weighted net present value to NAIC Designations and NAIC Designation Categories.

Securities Not Modeled by the SSG and Not Rated by an NAIC CRP or Designated by the SVO

27. Securities subject to *SSAP No. 43R—Loan-Backed and Structured Securities* that cannot be modeled by the SSG and are not rated by an NAIC CRP or designated by the SVO are either: (a) assigned the NAIC administrative symbol **ND** (not designated), requiring subsequent filing with the SVO; or (b) assigned the NAIC Designation for Special Reporting Instruction [i.e., an **NAIC 5GI** or **NAIC 6*** (six-star)].

Definition

28. A Mortgage Referenced Security is a category of a Structured Note, as defined in Part Three of this Manual. In addition to the Structured Note definition, the following are characteristics of a Mortgage Referenced Security: A Mortgage Referenced Security's coupon and/or principal payments are linked, in whole or in part, to prices of, or payment streams from, real estate, index or indices related to real estate, or assets deriving their value from instruments related to real estate, including, but not limited to, mortgage loans.

Quarterly Reporting for Mortgage Reference Securities *(pending adoption)*

29. To determine the NAIC Designation to be used for quarterly financial statement reporting for a Mortgage Reference Security purchased subsequent to the annual surveillance described in this Part, the insurer uses the prior year-end modeling data for that CUSIP (which can be obtained from the NAIC) until the annual surveillance data is published for the current year. For a Mortgage Reference Security that is not in the prior year-end modeling data for that CUSIP, the insurer may follow the instructions in Part Two of this manual for the assignment of the SVO Administrative Symbol "**Z**" provided the insurer owned security meets the criteria for a security that is in transition in reporting or filing status.

Not Filing Exempt

30. A Mortgage Referenced Security is not eligible for the filing exemption but is subject to the filing requirement.

NAIC Risk Assessment

31. In determining the NAIC Designation of a Mortgage Referenced Security, the SSG may use the financial modeling methodology discussed in this Part, adjusted to the specific reporting and accounting requirements applicable to Mortgage Referenced Securities.

Extension of Authority

32. The Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure is extended to the SSG, and the SSG is authorized to determine probable regulatory treatment for RMBS and CMBS pursuant to this Part or for other securities, where, in the opinion of the SSG, financial modeling methodology would yield the necessary analytical insight to determine probable regulatory treatment or otherwise enable the SSG to make recommendations to the VOS/TF as to regulatory treatment for a security.

Interpretation

33. To facilitate this purpose, wherever in the Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure reference is made to the SVO, it shall be read to also refer to and apply to the SSG, adjusting for differences in the operational or methodological context. The Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure shall also be read as authority for collaboration between SVO and SSG staff functions so as to encompass RTAS assignments that require the use of SVO financial, corporate, municipal, legal, and structural analysis and related methodologies, as well as of financial modeling methodologies.

G:\SECVAL\DATA\Vos-tf\Meetings\2020\April 2020\VOSTF 4.9.2020\Item 2 - RMBS-CMBS NAIC Designation Category\Attachment C -2 - 2019-016-01 - Task Force 2019 Amend PP to Part Four.docx

American Property Casualty Insurance Association
INSURING AMERICA apci.org

STEPHEN W. BROADIE
VICE PRESIDENT, FINANCIAL & COUNSEL

February 7, 2020

Charles Therriault
Director, Securities Valuation Office
National Association of Insurance Commissioners
One New York Plaza, Suite 4210
New York, NY 10004

Re: P&P Manual Amendment to Remove the Financial Modeling Instructions for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designation and NAIC Designation Categories for These Securities

Dear Mr. Therriault:

The American Property Casualty Insurance Association (APCIA) is pleased to comment to the NAIC's Valuation of Securities (E) Task Force on its proposal to eliminate the use of price points and break points in assigning NAIC designations to Residential Mortgage Backed Securities ("RMBS") and Commercial Mortgage Backed Securities ("CMBS"), and direct NAIC staff to produce NAIC designations and designation categories for those securities. Representing nearly 60 percent of the U.S. property casualty insurance market, APCIA promotes and protects the viability of private competition for the benefit of consumers and insurers. APCIA represents the broadest cross-section of home, auto, and business insurers of any national trade association. APCIA members represent all sizes, structures, and regions, which protect families, communities, and businesses in the U.S. and across the globe.

APCIA congratulates the Task Force on its decision to withdraw the proposed changes for 2020. We want to make it clear, however, that we will continue to oppose the proposal if it is reintroduced for 2021. We continue to believe that the concern that "with the upcoming implementation of NAIC designation categories, the new 20 additional granular delineations of credit risk, the complexity and expense to the NAIC and insurers to produce and incorporate the needed 19 price break points would be high" is unfounded. Since the modeling is done by sophisticated outside vendors, we expect that the additional analysis and effort required by the relevant vendors preparing the break points would be minimal. APCIA also requests that the NAIC consider the level of additional staff and resources necessary to properly evaluate these securities.

More importantly, eliminating the use of carrying or book value is inconsistent with the nature of the securities and may lead to improperly evaluating the risk of the securities. These securities all have multiple obligors and a diverse collateral pool, and modeling appropriately reflects the risk of future cash flows. Considering future cash flow against the remaining par value (as opposed to carrying or book value) of the applicable security will overstate the risk of future recovery. This structure was of tremendous value to the insurance industry post-financial crisis, prevented forced selling of securities, and has served the industry and its policyholders well in subsequent years.

If you or members of the Task Force have any questions or comments about our letter, please contact me at 847.553.3606 or steve.broadie@apci.org.

Sincerely,

Stephen W. Broadie

Experience the Power of Collaborative Thinking

February 7, 2020

Charles Therriault
Director
Securities Valuation Office

Attn: Denise Genao-Rosado, NAIC – dgenaorosado@naic.org

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Remove the Financial Modeling Instructions for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designation and NAIC Designations Categories for these Securities

Dear Charles:

We appreciate the opportunity to comment on the above referenced proposal, as exposed by the Valuation of Securities Task Force ("the Task Force") at the recent 2019 Fall National Meeting in Austin.

We empathize with the efforts to reduce the complexity of the transition to greater granularity in the depiction of credit risk within statutory filings (i.e. the move to twenty NAIC designation categories). However, we have concerns regarding the proposed elimination of the current process for deriving the final NAIC designation for RMBS/CMBS securities.

When the NAIC introduced its modeling approach with price breakpoints in 2009 and 2010, it accomplished several groundbreaking results:

1. Acknowledged the fundamental importance of the key drivers of loss severity in RMBS/CMBS, which result in a range of expected recovery outcomes, quantifiable via analysis of granular, loan-level collateral characteristics.
2. Established a framework for regulatory capital that more comprehensively considers the expected economic cost of holding RMBS/CMBS by recognizing discount to par as a tangible and impactful form of effective credit enhancement for these asset classes
3. Allowed the industry to consider investing in RMBS/CMBS during a period of great market stress, enabling prudent, quantitatively sound investments that both helped stabilize the market and drove healthy long-term returns for members

If price breakpoints are removed from the current process, these enhancements would be lost. The industry's ability to navigate future market stress events prudently and effectively would be reduced, and market stability significantly diminished.

Removing price breakpoints would materially degrade the current regulatory capital framework for RMBS and CMBS and precipitate untoward ripple effects across this important sector of the capital markets. Furthermore, doing so would, in a retroactive manner, adversely change the capital rules under which we have made prudent investment decisions over the last several years. Therefore we respectfully request that this proposal be withdrawn.

Fidelity & Guaranty Life Insurance Company
Two Ruan Center, 601 Locust Street, Suite 1400, Des Moines, IA 50309
1.888.697.LIFE • 515.244.1199 (fax) • fglife.com

Experience the Power of Collaborative Thinking

Thank you for your consideration of these concerns.

Sincerely,

Leena Punjabi
VP, Asset Management

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Mike Monahan
Senior Director, Accounting

Tracey Lindsey
President

January 31, 2020

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Ms. Carrie Mears, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64016-2197

Re: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)* to Remove the Financial Modeling Instructions for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designation and NAIC Designations Categories for these Securities

Dear Mr. Fry and Ms. Mears:

ACLI[1] and NASVA[2] ("the undersigned") appreciate the opportunity to comment on the above referenced proposal, as exposed by the Valuation of Securities Task Force ("the Task Force") at the recent 2019 Fall National Meeting in Austin.

We appreciate the ongoing collaboration with the IAO, in particular their efforts to reduce the complexity of the transition to greater granularity in the depiction of credit risk within statutory filings (i.e., the move to twenty NAIC designation categories). However, we continue to have concerns regarding the proposed elimination of the current process for deriving the final NAIC designation for RMBS/CMBS securities.

When the NAIC introduced its modeling approach with price breakpoints in 2009 and 2010, it accomplished several groundbreaking results:

1. Acknowledged the fundamental importance of the key drivers of loss severity in RMBS/CMBS, which result in a range of expected recovery outcomes, quantifiable via analysis of granular, loan-level collateral characteristics

[1] The **American Council of Life Insurers** (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States. Learn more at www.acli.com.

[2] The ***North American Securities Valuation Association*** (NASVA) is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes. Find more information here.

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North American Securities Valuation Association
contact: Tracey Lindsey, President
740-253-1016 lindset4@nationwide.com

2. Established a framework for regulatory capital that more comprehensively considers the expected economic cost of holding RMBS/CMBS by recognizing discount to par as a tangible and impactful form of effective credit enhancement for these asset classes

3. Allowed the industry to consider investing in RMBS/CMBS during a period of great market stress, enabling prudent, quantitatively sound investments that both helped stabilize the market and drove healthy long-term returns for members

If price breakpoints are removed from the current process, these enhancements would be lost. The industry's ability to navigate future market stress events prudently and effectively would be reduced, and our ability to help support market stability significantly diminished.

There is a wide consensus among the undersigned's memberships that removing price breakpoints would materially degrade the current regulatory capital framework for RMBS and CMBS and precipitate untoward ripple effects across this important sector of the capital markets. Furthermore, doing so would, in a retroactive manner, adversely change the capital rules under which many of our members made prudent investment decisions over the last several years. To the extent that cost is a consideration, the third-party costs relating to the calculation of price breakpoints is borne by those insurers who hold the applicable securities, and our members believe that any increase in costs due to the transition to 20 designation categories will be outweighed by the benefits of maintaining this superior RBC framework in its current state. Therefore we respectfully request that this proposal be withdrawn.

If the Task Force has appetite for a more detailed elaboration on our position and the attendant reasoning, we would welcome and solicit Task Force instruction to that effect. We stand ready to walk through how the current process works and illustrate its efficacy in providing a reasonable view of owned assets' credit risks based on both the type of asset and the carry value held.

Please do not hesitate to contact either of us should you have any questions. Thank you.

Sincerely,

M Monahan

Senior Director, Accounting Policy
American Council of Life Insurers

Tracey Lindsey

President
North American Securities Valuation Association

cc: Mr. Charles Therriault, Director, SVO
Mr. Marc Perlman, Investment Counsel

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

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group
Marc Perlman, Investment Counsel, NAIC Securities Valuation Office

DATE: January 27, 2020

RE: Updated **-** Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Update the Definition and Instructions for Principal Protected Notes

---

1. **Summary** –The Task Force on the Oct. 31 call directed NAIC staff to work with industry on the definition for Principal Protected Securities. NAIC staff reported at the Fall National Meeting that it had met with industry representatives on Dec. 3, Nov. 22, Nov. 15 and Nov. 8. The attached updated amendment reflects the discussions to date and staff's recommendation for a definition of this security; including, expanding this to a new P&P Manual section that provides examples. The update is consistent with the general framework that was outlined at the Fall National Meeting.

2. **Recommendation** – NAIC staff recommends exposing this updated amendment for comment (new text is identified in red).

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

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

PRINCIPAL PROTECTED NOTES

Defined

115. Principal Protected Notes (PPNs) are a type of security that repackages one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s) but for which the repackaged security generates potential additional returns as described in the detail criteria for PPNs, along with examples, in Part Three of this Manual.

Intent

116. Transactions meeting the criteria of a PPN as defined this Manual may possess Other Non-Payment Risks and must be submitted to the SVO for review under its Subscript S authority.

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:

...

- **Principal Protected Notes (PPN) -** Transactions meeting the criteria of a PPN as specified in this Manual may possess Other Non-Payment Risks and must be submitted to the SVO for review under its Subscript S authority.

...

PRINCIPAL PROTECTED NOTES

Definition

324. Principal Protected Notes (PPNs) are a type of security that repackages one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s) (including principal and, if applicable, interest, make whole payments and fees thereon) that if purchased by an insurance company on a stand-alone basis would be eligible for Filing Exemption, but for which:

(i)

a. the repackaged security structure enables potential returns from the underlying investments in addition to the contractually promised cash flows paid to such repackaged security according to a fixed schedule;

OR

b. the contractual interest rate paid by the PPN is zero, below market or, in any case, equal to or below the comparable risk-free rate;

AND

(ii) the insurer would obtain a more favorable Risk Based Capital charge or regulatory treatment for the PPN through Filing Exemption than it would were it to separately file the underlying investments in accordance with the policies in this Manual.

Exclusions

325. For the avoidance of doubt, PPNs shall not include defeased or pre-refunded securities which have separate instructions in this Manual; broadly syndicated securitizations, such as collateralized loan obligations (CLOs) (including middle market CLOs) and asset backed securities (ABS), except as described in the examples in this section; or CLO or ABS issuances held for purposes of risk retention as required by a governing law or regulation.

Filing Requirements

326. Investments in PPNs must be submitted to the SVO for review because they may possess Other Non-Payment Risks that the SVO must assess under its Subscript S authority. If the SVO determines in its judgement that there are not any Other Non-Payment Risks, the SVO will permit the security to benefit from Filing Exemption, if it is otherwise eligible.

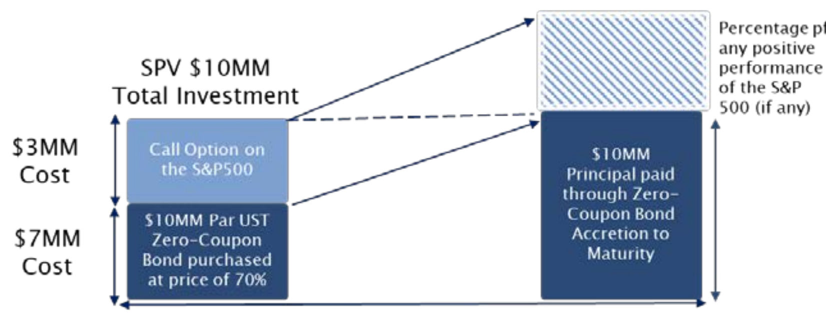
327. In addition to *Filing Process and Required Documents* outlined in Part Two of this manual, the following additional information is required for PPNs:

- Disclosure of any Subsidiary, Controlled or Affiliated relationship between the PPN or any of the underlying investments and the insurer; including, how the underlying investments were acquired.
- Prior four quarterly financial statements, if produced, trustee or collateral agent reports from the entity issuing the PPN sufficient to identify: security specific details of each underlying investment (security identifier, descriptive information, all Eligible NAIC CRP Credit Ratings (if any), par value, market value, and explanation as to how the market value was determined).

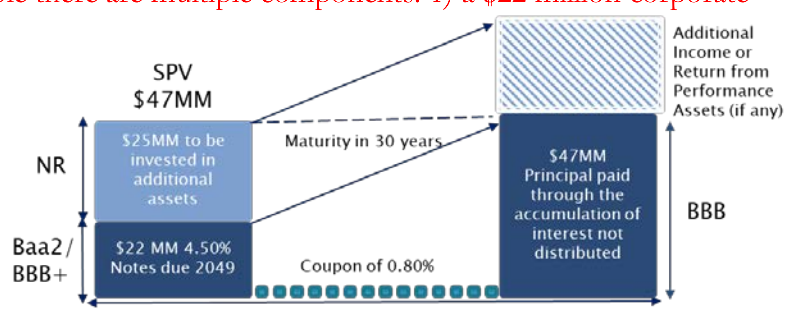
Example Transactions

328. The following transaction examples are included for demonstrative purposes only, to highlight the core regulatory concern (that there are Other Non-payments Risks associated with PPNs beyond the contractually promised payments that may not be reflected in a CRP rating) but are not intended to encompass all possible PPN variants. Each of these examples meets the definition of a PPN.

329. In this initial example there are only two components: 1) a $10 million par United States Treasury (UST) zero-coupon bond sold at discount (ex. $70) from par ($100) that will pay par ($100) at maturity and 2) a return linked to any positive performance of call options on the S&P 500 Index (if the S&P 500 Index has a negative performance, investors will only receive an amount equal to their initial investment). The CRP rating would be AAA/AA+ or an NAIC 1.A, based solely on the risk of the UST security; whereas, the Weighted Average Ratings Factors (WARF) applied by the SVO would result in an NAIC 4.B when it includes the exposure to the call options on the S&P 500 Index.

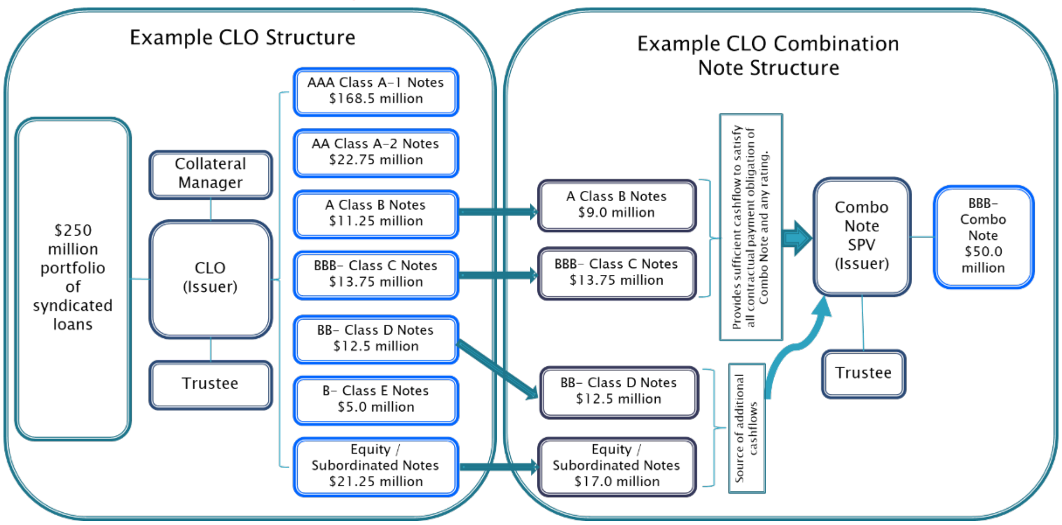


330. In the second example there are multiple components: 1) a $22 million corporate bond paying a fixed coupon (ex. 4.50%) with a stated maturity date (ex. 9/30/2049), 2) the corporate bond has two CRP ratings (Moody's Baa2, S&P



BBB+), 3) the Special Purpose Vehicle (SPV) also invests $25 million in additional undisclosed and unrated assets, 4) the SPV pays a below market semi-annual coupon of 0.80%, 5) the excess coupon difference (4.50% - 0.80% = 3.70%) is used to accumulate into the required principal to pay at maturity, and 6) a CRP rated the PPN a BBB or NAIC 2.B. , Again, the PPN rating is based solely on the corporate bonds that represent less than 50% of the total investment in this example, whereas, the WARF methodology would result in an NAIC 4.C when the exposure to all of the underlying investments are included.

331. The third example is a repackaging of collateralized loan obligation (CLO) notes into a CLO Combination Note (Combo Note). The initial CLO holds $250 million of syndicated loans and issues $255 million of notes (the CRP rating for each tranche is listed before the Class, ranging from AAA to B-) and Equity / Subordinated Notes. The Combo Note is formed in this example by re-packaging the Class B, C, D, and Equity / Subordinated Note tranches together. The total notional amount of all the tranches in the



Combo Note is $52.25 million. The Combo Note raises proceeds by issuing a single $50 million notional tranche of debt through an SPV. The cashflows from the Class B and C notes are sufficient to repay the $50 million Combo Note principal and interest, if any; which, may constitute a reclassification of the Class B and C tranche interest to repay principal on the Combo Note. Payments from the underlying investments in the Class D and Equity / Subordinated Note tranches provide returns to the repackaged security in addition to the contractually promised cash flows according to a fixed schedule that are based upon the payments from the Class B and Class C Notes. The Combo Note receives a BBB- rating or NAIC 2.C on the notional of $50 million based upon payments from the Class B and C tranches even though $29.5 million or 57% of the underlying investments are rated BB- or unrated, whereas, the WARF would result in an NAIC 4.B when the exposure to all of the underlying investments are included.

From: Connie Jasper Woodroof
To: Therriault, Charles A.
Cc: Genao-Rosado, Denise
Subject: RE: VOSTF Exposures - Comments
Date: Monday, February 24, 2020 9:57:49 AM

|*|*|*|CAUTION: This email originated from outside of the organization. Do not click links or open attachments unless you recognize the sender and know the content is safe.|*|*|*

On Feb 23, 2020, at 12:14 PM, Connie Jasper Woodroof <c.jasperwoodroof@sapiens.com> wrote:

Principal Protected Notes proposal – The use of PPN to signify Principal Protected Notes is problematic. The PPN initialism is already used both in the Purposes and Procedures Manual of the NAIC Investment Analysis Office and the various editions of the Annual Statement Instructions to indicate a Private Placement Number issued by S&P and reported in the CUSIP field of various filings.

Whatever decision is made regarding the initialism, that decision should be consistently applied. In the definition section of the proposal (page 3), the first paragraph indicates using PPNs. However, the second paragraph uses only PPN (no s). On page 5 addressing filing exemption, PPN is once again used, while on page 6 the first paragraph uses PPNs. This type of inconsistency exists throughout the document.

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Mike Monahan
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Tracey Lindsey
President

March 5, 2020

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Ms. Carrie Mears, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64016-2197

Re: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update the Definition and Instructions for Principal Protected Notes (PPNs)

Dear Mr. Fry and Ms. Mears:

ACLI[1] and NASVA[2] ("the undersigned") appreciate the opportunity to share our comments on the Updated Definition and Instructions for Principal Protected Notes with the Valuation of Securities Task Force ("the Task Force"). The undersigned appreciate the productive dialogue with the Securities Valuation Office ("SVO") and Structured Securities Group ("SSG") that has culminated in sufficiently clear guidance as to scope. We support the exposed scope guidance, as drafted, as a workable mechanism for fully addressing the pertinent analytical concern via a practical methodology. As the Task Force turns attention to the practical considerations of implementation, we solicit your continued engagement in addressing two distinct, but related, and critically important needs: sharing further insight into the key dynamics of the analytical methodology for deriving NAIC designations that will dictate the capital efficiency of such investments, and additional detail on the new administrative filing procedures.

In order to provide insurance companies the requisite insights for assessing the feasibility of allocations to PPN (and potentially other) investments as components of the broader strategies employed in the prudent management of their investment portfolios, we would like to achieve a better feel for the key dynamics and assumptions that typically drive the results of the NAIC's Weighted Average Rating Factor ("WARF") methodology. We understand that any general NAIC rating methodology must afford a measure of leeway for analytical discretion to address the diversity of structural features of a given investment

[1] The ***American Council of Life Insurers*** (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States. Learn more at www.acli.com.

[2] The ***North American Securities Valuation Association*** (NASVA) is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes. Find more information here.

vehicle. However, insurance companies should understand the capital implications of investment decisions before a purchase. The above proposal contrasts the ratings of securities from the rating agencies with those of the NAIC's WARF methodology. It would be valuable if a walkthrough using the specific examples highlighted in paragraphs 329 through 331 could be provided to illustrate the key dynamics and assumptions that drive the NAIC designations resulting from the application of the WARF methodology. This may entail additional information, such as specificity of the coupon rate or return, for example, for the PPN example highlighted within paragraph 329. It could also entail further insight as to the manner in which the WARF methodology accounts for the passage of time and the attendant changes in the relative proportions of contractually promised payments covered by the underlying Filing Exemption eligible bonds versus those covered by other assets in the structures as the whole vehicle progresses towards maturity. Providing this additional information would help insurance companies make more informed decisions about risk adjusted portfolio allocations viewed through the lens of the NAIC solvency framework.

As we will have a new filing process for these securities, which will entail new administrative filing procedures for obtaining the NAIC designations, NASVA and ACLI member insurers would find it beneficial to work with the SVO to expeditiously refine and/or develop these procedures to eliminate as much as possible the uncertainties that will exist between now and year-end when such new NAIC designations will be needed, and eliminate uncertainty on-going for future investment purchases.

Please do not hesitate to contact either of us should you have any questions. Thank you.

Sincerely,

Tracey Lindsey

Senior Director, Accounting Policy
American Council of Life Insurers

President
North American Securities Valuation Association

cc: Mr. Charles Therriault, Director, SVO
Mr. Marc Perlman, Investment Counsel

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March 5, 2020

Submitted electronically to ctherriault@naic.org and dgenaorosado@naic.org

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Ms. Carrie Mears, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Updated - Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office ("P&P Manual") to update the Definition and Instructions for Principal Protected Notes ("PPNs") (the "Exposure")

Dear Mr. Fry and Ms. Mears:

We appreciate the opportunity to comment on the NAIC Valuation of Securities Task Force (the "Task Force") Exposure. Security Benefit Life Insurance Company ("SBL") is a Kansas domiciled company licensed in 49 states and the District of Columbia, with approximately $40 billion in assets under management. Over the past several years, SBL has invested in both Collateralized Loan Obligations ("CLOs") and CLO Combo Notes, the latter of which the Exposure now proposes to add to the definition of PPNs. It appears that this change is being proposed, at least partially, as a consequence of two reports by the NAIC's Capital Markets and Investment Analysis Office ("CMIAO").[1] This concerns us because these reports reach conclusions based on certain assumptions from inaccurate data. This perspective is further supported by a recently published Bank of America Global Research report, included here as Appendix II. We expand on this point later in the letter.

While we continue to support the Task Force's and the CMIAO's overall efforts to maintain the NAIC's credit assessment process for insurer-owned securities, including research and analysis of insurer investments, in light of the referenced CMIAO's reports we respectfully suggest:

- that the Task Force commission a thorough, independent analysis of the expected performance of CLO Combo Notes, which would have the benefit of providing the Task Force with additional information regarding an appropriate rating methodology; and

- that the Task Force adopt a suitable transition period before any significant modifications to the existing framework would apply.

[1] "Update on Leveraged Loans," published August 5, 2019 and "Collateralized Loan Obligations Stress Testing U.S. Insurers' Year End 2018 Exposure," published on December 6, 2019.

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Scope of Proposed PPN Definition

The new PPN definition proposed by the Task Force is broad and would cover a wide range of assets with securitization features. However, the assets used to illustrate the scope of the new definition are not similar in kind. The first two examples provided in the Exposure are commonly known in the market as PPNs, which pair a traditional asset with what the CMIAO calls a "performance asset". We support the CMIAO's and Task Force's effort to increase transparency into such performance assets in these transactions, which we believe the industry understood to be the goal of the initial memorandum on PPNs dated July 2, 2019, which the Task Force exposed in August 2019 (the "Initial Exposure").

The third example is a Combo Note, which is significantly different than traditional PPNs. The performance of the Combo Note is based on a diversified portfolio of term financed, senior secured loans which have a transparent and proven track record, which can be analyzed by a wide range of investors on Intex, a software system utilized industry wide. Historical data on CLOs, including CLO Residual Tranches, which represent the unrated first loss 10% of a term financed CLO ("CLO equity") exists for more than 20 years of issuance and is the subject of substantial public analysis by investment banks, hedge funds, institutional investors, asset managers, and nationally recognized statistical rating organizations ("NRSROs"). As illustrated by CLO Residual Tranches, not every asset that would be swept into the Exposure presents the same risks that the CMIAO and Task Force identified in the Initial Exposure.

While we agree that the PPN initiative is, and should be, about transparency and appropriately measuring credit risk, we also believe the CMIAO is making a fundamentally different credit-risk based argument about CLO Combo Notes. Grouping these assets together solely because they contain some common structural features is, in our opinion, unnecessary to preserve the CMIAO's and Task Force's original goal of reviewing PPN structures for transparency and investment suitability.

Independent Analysis and Rating Methodology

We and other market participants are concerned (details are included in Appendices I and II included with this letter), that the CMIAO reports utilize inappropriate data, analysis, and assumptions. In short, we and others believe that:

- The analyses use old data, dating to the 1970s, and excludes more recent data (since 2009) available from both S&P and Moody's. Furthermore, more recent post-crisis CLO structures are stronger than those that existed prior to the most recent Global Financial Crisis from which much of the data is drawn.

- The analyses use a "cohort" rating analysis for default assumptions rather than using the more appropriate life-to-date since issuance analysis.

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- The stress analysis on senior secured loans is extreme and uses recovery assumptions over unrealistic extended periods that reflect unsecured bank debt recovery rates rather than much more relevant secured bank debt recovery rates, even though first lien secured bank debt comprises over 90% of the assets underlying CLOs. [2]

- The CMIAO's claim of high losses in CLO Combo Notes is based on stress scenarios that are not disclosed.

- The analysis gives no credit to the active management of CLOs, which has allowed CLOs to experience meaningfully lower loan defaults in comparison to the broader market, as well as allowed collateral managers to increase par value during volatile market periods.

- CLO Combo Notes provide additional investor protections *vis-a-vis* holding only the underlying CLO debt tranches, such as the ability to refinance, reset, or call the CLO structure and work closely with CLO managers on structures. Each SBL CLO Combo Note includes tranches from only a single CLO issuer.

We understand the concern that different capital requirements might apply if the underlying components of a CLO Combo Note were held directly. However, we believe the NRSRO ratings more appropriately reflect the credit quality of CLO Combo Notes as opposed to a Weighted Average Rating Factor ("WARF") methodology, which the CMIAO has suggested it might use. In addition to the demonstrable historical and expected performance of CLO Combo Notes, we also believe in the appropriateness of the NRSRO CLO Combo Note ratings because rating agencies rate underlying CLO tranches much more conservatively than the actual default experience would imply. For example, 'Baa' to 'B' CLO tranches should be rated 'A' based upon actual life-to-date impairments, as further detailed in Appendix I.

Accordingly, we believe that CLO Combo Notes should not be included within the definition of PPNs and should remain exempt from filing. However, if these instruments are to be included, then the methodology used to rate CLO Combo Notes should be fully and thoroughly vetted based on appropriate empirical data, more realistic assumptions, and finer analysis.

We believe independent expert analysis would provide the Task Force with, among other things, a necessary additional resource on the transparency of the CLO market, the credit risk and rating methodology of CLOs and CLO Combo Notes, and the manner in which CLOs and CLO Combo

---

[2] The severity of the stress testing assumes an economic environment far worse than the most recent Global Financial Crisis, in terms of the degree of economic disaster, and assumes the same extremely stressed recovery rate for 10 years. According to Chris Flanagan, the author of the BofA Global Research report included in Attachment of Appendix II, "[a] stress test is always useful but if stresses are nowhere in the realm of reality anything can break down." Indeed, in the extremely unlikely event that the assumed economic environment became reality, we believe many unsecured investment grade corporate bonds would suffer massive, near total losses as well.

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Notes are structured and function. This analysis could be conducted in a short period of time and we would be willing to fund it. Further, we would be happy to share our analysis on CLO's to offer what we believe will be an alternative view of the credit risk of the investments relative to what is currently being presented to the Task Force.

Transition Period

Although an effective date for the change has not yet been specified, we understand that, in the event CLO Combo Notes are ultimately included within the scope of the PPN definition, December 31, 2020 is a potential effective date. At a minimum, companies that have lawfully accumulated CLO Combo Note holdings should be afforded at least another year to provide for a reasonable transition period. Although the CLO market is approximately $700 billion, transparent and deeply liquid, large volume sales in a quicker than typical transition timeframe may result in unfair losses to companies who have long relied on the current regulatory capital rules.

***

In summary, we thank you for your efforts and attention to our concerns regarding this important matter. We remain committed to working with you to develop an appropriate way to satisfy regulatory objectives regarding CLO Combo Notes and your belief that the NRSRO ratings do not adequately reflect the appropriate level of risk. We would welcome and opportunity to meet with and present our analysis on CLO's to the Task Force in person, which we believe would provide an alternative view of the credit risk of the investments.

Sincerely,

Joseph W. Wittrock, CFA
Senior Vice President and
Chief Investment Officer

John F. Guyot
Senior Vice President,
General Counsel and Secretary

Appendix I

1. CLO Performance (August CMIAO Report)

Summary

- The CMIAO published a report titled "Update on Leveraged Loans", dated August 5, 2019
- The report states that "Historically, CLOs have been one of the best performing structured finance assets. Moreover, CLOs have also performed better at the Aaa-A levels than corporates." However, it also raises concerns that "If during the next recession leveraged loan default at a higher rate and experience lower recoveries, CLOs will also underperform compared to historical levels."
- In particular, the report refers to a 12.2% impairment on CLO BBB tranches and a 31.3% impairment on CLO BB tranches.

  CMIAO uses the below table in its report:

Rating	CLO impairment(1)	CDO ex-CLO impairment(1)	Structured Finance impairment(1)	Corporate Default Rate(2)
Aaa	0%	34.8%	14.9%	0.2%
Aa	0%	50.6%	32.1%	1.0%
A	0.1%	56.5%	46.6%	3.0%
Baa	12.2%	65.5%	59.0%	4.2%
Ba	31.3%	68.7%	59.4%	19.3%

- The report highlights historical performance of CLOs versus other asset classes (CDOs, structured finance, and corporates), which we believe raises a number of questions regarding the chosen data set, including:
  - A Time period covered in the report
  - B Use of a cohort impairment rate versus long-term default statistic based on original issuance ratings

Data Period

A The report used performance data for period 1993-2013 published in a September 2014 Moody's report[1]

- The analyses use old data, dating to the 1970s, and excludes more recent data (since 2009) available from both S&P and Moody's.[2]
- Moody's itself uses its more recent report (for the period 1993-2018) when talking about CLO credit risk, which captures the most recent five years of data and the performance of "post-crisis" structures that have been in place since the financial crisis of 2008
- **All of the defaults on Moody's rated CLO tranches occurred in transactions issued before the financial crisis**
- Methodologies for all agencies were revised again after the financial crisis of 2008 and "**post-crisis" CLO structures now contain no unsecured bonds, or structured finance securities, and a smaller percentage of non-first-lien senior secured loans than previously allowed**
- **"Post-crisis" structures have more subordination with credit support effectively improving by one rating level since the crisis**
- As an example, below is a comparison of certain concentration limitations of two Ares-managed CLOs issued pre-crisis versus post-crisis, as well as a table showing the improvement in credit enhancement levels between "pre-crisis" and "post-crisis" CLOs

Ares Concentration Limitations	Pre-Crisis	Post-Crisis
Deal	Ares X	Ares XLVI
Closing Date	Sept 2005	Jan 2018
Senior Secured Loans	Min 80%	Min 96%
Senior Unsecured and Subordinated Debt Securities	Max 10%	Max 0%
Structured Finance Securities	Max 5%	Max 0%
Synthetic Securities	Max 20%	Max 0%
Finance Leases	Max 5%	Max 0%

Credit Support[3]		
Original Rating	Pre-Crisis	Post-Crisis
AAA	25.0%	35.1%
AA	18.6%	23.6%
A	12.8%	17.3%
BBB	8.1%	11.9%
BB	5.6%	7.8%

(1) Moody's Default & Loss Rates of Structured Finance Securities: 1993-2013, dated September 30, 2014, (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF380976)
(2) Moody's Impairment and Loss Rates of Global CLO: 1993-2018, dated May 17, 2019, (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_1164579)
(3) Wells Fargo Securities "FAQ on CLOs and Leveraged Loans", dated January 31, 2019. Credit support is defined as the amount of capital below a given tranche in the transaction

Analysis on Cohort vs. Original Rating

B The numbers used to represent CLO impairment are from "cohort rating" analysis by Moody's, which is a more common performance measure for corporates

- Cohort-level cumulative impairment rates are calculated based on pools of CLO tranches with cohort ratings as of certain dates
- If on the next cohort formation date, the rating of a CLO tranche has migrated to a different rating category, the CLO tranche will be moved to a new cohort for the following cohort formation dates (i.e. an 'A' tranche that is downgraded to 'Baa' will be removed from the 'A' pool, and added to the 'Baa' pool). Thus, cohort analysis does not track rated issuances but shifting pools of assets that may change month over month and year over year
- There are multiple drawbacks to analyzing CLO performance based on cohort rating
  - **Analysis based on cohort rating may lead to higher impairment rates due to adverse selection**, as the non-defaults/performing tranches tend to prepay early, leaving the "weaker" tranches outstanding in the pool, as opposed to corporates, where better-performing names tend to stay outstanding longer
    - A CLO tranche may be included in multiple cohorts when calculating the cumulative impairment rate. The analysis ignores original rating of the bond and time since issuance
    - The pool of assets formed on a cohort formation date may include tranches that are more seasoned than the impairment time horizon (i.e. a 10-year cumulative impairment rate may include a CLO tranche that is outstanding for over 10 years)
  - **Small cohort size may also reduce the accuracy of the analysis**
  - Cohort rating analysis may be more useful in measuring performance for rating actions (upgrades or downgrades), but **does not accurately capture the long term performance on all tranches issued at a certain rating category**
- Cumulative impairment rates based on original rating is a better measure for CLO investments over a longer horizon, as it is a more "pure" measure
  - This approach measures the performance of every CLO tranche only once from the time of original issuance

Analysis on Cohort vs Original Rating (cont'd.)

- Moody's also publishes a long-term default statistic based on original issuance ratings (in particular, the life-to-date impairment rate), which is a more logical number to assess long-term credit risk.(1) S&P has similar statistics
  - Impairment rates(2) computed based on original rating would retain all tranches issued with such original rating in the data set, which more accurately captures the performance of each CLO tranche since issuance
  - These long-term numbers prove that **CLOs are in fact more conservatively rated, given historical default/loss performance, than any other credit asset class**

10-Year Cumulative Impairment Rates by Original Rating (Period 1993 - 2018)

Rating	CLO	CDO ex-CLO	US ABS	US CMBS	US RMBS	Structured Finance
Aaa	0.0%	39.1%	1.6%	4.8%	34.3%	26.0%
Aa	0.0%	48.2%	7.3%	18.3%	54.9%	39.7%
A	0.1%	53.1%	8.8%	24.1%	72.2%	46.4%
Baa	2.3%	62.4%	18.7%	31.8%	85.5%	60.8%
Ba	5.5%	60.7%	40.4%	51.6%	87.7%	57.4%

Life-to-Date Cumulative Impairment Rates by Original Rating (Period 1993 - 2018)

Rating	CLO	CDO ex-CLO	US ABS	US CMBS	US RMBS	Structured Finance
Aaa	0.0%	31.0%	0.7%	2.3%	22.6%	14.7%
Aa	0.0%	37.8%	4.2%	12.6%	51.5%	31.5%
A	0.0%	41.0%	4.4%	19.5%	67.7%	35.3%
Baa	1.2%	48.3%	6.9%	24.1%	78.4%	45.6%
Ba	2.2%	44.9%	16.1%	46.5%	76.7%	39.2%

(1) Moody's Impairment and Loss Rates of Structured Finance Securities: 1993-2018 – Excel Supplement, dated May 16, 2019 (https://www.moodys.com/research/Impairment-and-loss-rates-of-structured-finance-securities-1993-2018--PBS_1174732)
(2) Moody's defines impairment as, "A security is impaired when investors receive — or expect to receive with near certainty — less value than would be expected if the obligor were not experiencing financial distress or otherwise prevented from making payments by a third party"

S&P CLO Performance

- S&P published a report [(1)] on CLO performance in January 2014, that provided CLO default and loss data on all S&P-rated U.S. CLO tranches over a 20-year period
  - The data set shows that CLOs have resilient performance over the long-term, with historical defaults and losses at very low levels. Furthermore, all S&P-rated defaults occurred on tranches issued before the financial crisis

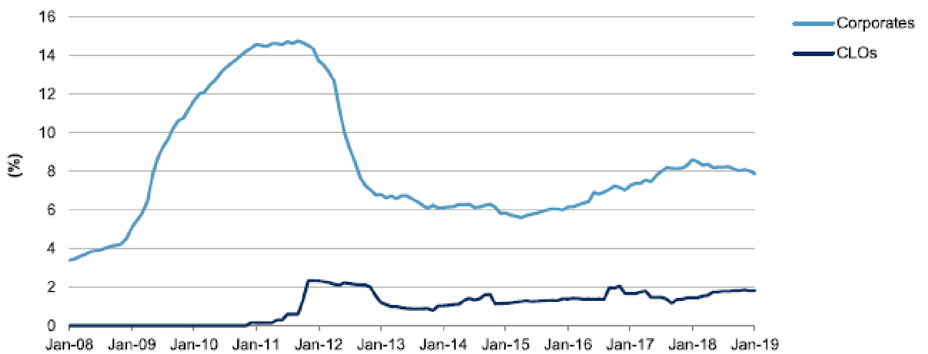
U.S. CLO Ratings 1994 - 2013: Defaults And Losses

Original rating	Total tranches(i)	Defaulted tranches	Default rate§	Loss rate†
AAA	1,992	0	0.00%	0.00%
AA	1,005	0	0.00%	0.00%
A	1,119	5	0.45%	0.08%
BBB	1,069	3	0.28%	0.21%
BB	841	14	1.66%	0.78%
B	115	3	2.61%	1.13%
Total	6,141	25	0.41%	0.04%

(i)Includes all U.S. cash flow CLO tranches ever rated as of year-end 2013. §Default rate = number of ratings that had ratings lowered to D/total number of ratings. †Loss Rate = sum of losses divided by sum of issuance amounts; market values from trustee reports used to estimate tranche losses when necessary; tranches without available loss data excluded. CLO--Collateralized loan obligation.

- When compared to corporates, another S&P report [(2)] (dated June 2019) showed that the speculative-grade three-year trailing default rates (before recoveries) for CLOs have been much lower

Global Speculative-Grade Three-Year Trailing Default Rates
CLOs versus corporates



Source: S&P Global Fixed Income Research.

(1) S&P Twenty Years Strong: A Look Back at US CLO Ratings Performance from 1994 through 2013, dated January 31, 2014 (https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/8447971)
(2) S&P 2018 Annual Global Leveraged Loan CLO Default And Rating Transition Study, dated June 19, 2019 (https://www.spglobal.com/_media/documents/2018-annual-global-leveraged-loan-clo-default-and-rating-transition.pdf)

CLO Performance Measures

- The correct reference for long-term credit risk in Baa CLO bonds are the 10-year horizon numbers and Life-to-Date numbers based on original ratings, for CLOs issued between 1993 and 2018
- The CMIAO report used an impairment assumption that is inappropriate and 10x the actual risk experience for CLOs, misrepresenting the actual credit experience of these products and their loss performance by rating
- This seems odd when the CMIAO itself refers to CLOs as having "sound structural features"(1)
- Independent analysis and further deliberation is warranted

	Moody's					S&P
	A 10-Year Horizon			A	Life-to-Date	Life-to-Date
Data Period	1993-2013	1993-2018	1993-2013	1993-2018	1993-2018	1994-2013
Rating	CLO Impairment B (Cohort Rating)(2)	CLO Impairment (Cohort Rating)	CLO Impairment (Original Rating)(2)	CLO Impairment B (Original Rating)(3)	CLO Impairment (Original Rating)(3)	Default Rate(4)
Aaa	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Aa	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
A	0.1%	0.0%	0.2%	0.1%	0.0%	0.5%
Baa	12.2%	5.3%	4.6%	2.3%	1.2%	0.3%
Ba	31.3%	13.1%	17.6%	5.5%	2.2%	1.7%

CMIAO Impairment

Moody's Long Term Impairment

S&P Long Term Default

(1) Executive Summary of "Collateralized Loan Obligations (CLOs) Primer", dated August 21, 2018, by Jennifer Johnson
(2) Moody's Default & Loss Rates of Structured Finance Securities: 1993-2013, dated September 30, 2014, (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF380976)
(3) Moody's Impairment and Loss Rates of Global CLO: 1993-2018, dated May 17, 2019, (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_1164579)
(4) S&P Twenty Years Strong: A Look Back at US CLO Ratings Performance from 1994 through 2013, dated January 31, 2014 (https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/8447971)

2. CLO Stress Testing (December CMIAO Report)

Overview

- In December of 2019, the CMIAO published a paper[1] detailing the results of a series of stress tests on CLOs owned by U.S. insurance companies

- In the report, the CMIAO uses default data to calculate its own default vector, which overstates defaults by 3-4 percentage points compared to the Moody's published vector in both shorter and longer time horizons

- In two of the stress scenarios, the CMIAO uses an **unsecured** recovery rate that ignores the senior **secured** nature of the collateral in CLO pools

- CMIAO claims to see 28-30% "losses to principal" in combo notes across the three stress scenarios without disclosing its sample set, methodology, or calculations

(1) "Collateralized Loan Obligations – Stress Testing U.S. Insurers' Year-End 2018 Exposure", dated December 6, 2019, by Azar Abramov, Jean-Baptiste Carelus, Jennifer Johnson, Eric Kolchinsky, Hankook Lee, and Elizabeth Muroski

CMIAO Scenarios

- The analysis included three scenarios with various assumptions
  1) SCENARIO (A)
     - Default: historical default vector
     - Recovery: first lien bank loan recovery rate (64%)
  2) SCENARIO (B)
     - Default: historical default vector
     - Recovery: senior unsecured bank loan recovery rate (40%)
  3) SCENARIO (C)
     - Default: historical default vector + 1 standard deviation
     - Recovery: senior unsecured bank loan recovery rate (40%)
- The stress testing was conducted on $95.9B of "normal" tranches and $1B of "atypical" tranches (i.e. combo notes)
- The analysis invites a number of questions and concerns
  1) the default and recovery assumptions
  2) the sample set used in the analysis
  3) the methodology for computing principal loss
  4) the conclusion of the analysis

Stress Testing Methodology: Default Assumptions

- The historical corporate default vector used in the CMIAO stress analysis is for the period 1970-2009. CMIAO determines the cumulative default vector by recalculating an existing vector found in Exhibit 44 of the Moody's Annual Default Study[2] in order to capture an earlier data period, and cut off data within a 10-year time horizon (even though many corporates, like most senior secured loans, have shorter than 10-year lives)
- The below table is the default vector generated by CMIAO for the period 1970-2009 used in Scenarios (A) and (B) of the CMIAO analysis[1]

1

CMIAO Cumulative Default (1970-2009)

Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	2.7%	6.7%	10.9%	14.7%	18.5%	21.9%	25.3%	28.2%	30.8%	32.9%
B2	4.0%	9.8%	15.1%	19.7%	23.4%	26.8%	29.7%	32.1%	34.3%	36.4%
B3	6.5%	13.6%	20.2%	25.7%	30.4%	34.4%	37.9%	40.9%	43.5%	45.5%

- The methodology that CMIAO used to generate the cumulative default vector differs from Moody's approach when it calculates its published vector. CMIAO uses a simple weighted average method to calculate its vectors, while Moody's uses a more comprehensive approach which relies on marginal default rates
- CMIAO's decision to capture the period beginning in 1970 is not the best representation of historical default statistics. Moody's intentionally chooses to publish its weighted average cumulative default vectors beginning in 1983 as the periods before that have few samples, and 1983 was the first year Moody's created sub-notches for its ratings categories (*i.e.*, broke the 'B' rating into 'B1', 'B2', and 'B3')

(1) Moody's Annual default study: Defaults will rise modestly in 2019 amid higher volatility, dated February 1, 2019 (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1156859)

Stress Testing Methodology: Default Assumptions (con't.d)

- We regenerated the cumulative default vectors for the 1983-2018 period using the methodology described by the CMIAO stress report and find the approach results in a higher default vector than the one published by Moody's
- Below is a more recent default vector for the 'B' rating category published by Moody's that captures the more recent period 1983-2018[2]

2

Moody's Cumulative Default (1983-2018)										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	2.0%	5.3%	8.9%	12.4%	16.0%	19.3%	22.5%	25.3%	27.7%	29.7%
B2	3.0%	7.7%	12.4%	16.7%	20.3%	23.6%	26.4%	28.7%	30.9%	32.9%
B3	4.9%	10.7%	16.6%	21.7%	26.2%	30.3%	33.7%	36.7%	39.1%	41.1%

- We recalculated the 1983-2018 default vectors using CMIAO's methodology:

3

CMIAO Cumulative Default (1983 - 2018)										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	2.0%	5.2%	8.9%	12.6%	16.4%	20.0%	23.6%	27.0%	30.3%	33.1%
B2	3.0%	7.6%	12.4%	16.9%	20.7%	24.4%	27.7%	30.7%	33.7%	36.6%
B3	5.0%	10.5%	16.6%	22.0%	26.8%	31.4%	35.4%	39.2%	42.7%	45.7%

- CMIAO's methodology overstates the vectors by as much as 4.6 percentage points towards the longer time horizons:

3 - 2

CMIAO Cumulative Default versus Moody's Cumulative Default (1983-2018)										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	0.0%	-0.1%	0.0%	0.2%	0.3%	0.7%	1.1%	1.8%	2.5%	3.3%
B2	0.0%	-0.1%	0.0%	0.2%	0.4%	0.9%	1.3%	2.0%	2.8%	3.7%
B3	0.1%	-0.2%	0.0%	0.3%	0.6%	1.1%	1.7%	2.5%	3.6%	4.6%

- The combined impact of the earlier time period and different weighting methodology used in CMIAO's analysis overstates cumulative default rates in shorter time horizons as well

1 - 2

CMIAO Cumulative Default (1970-2009) versus Moody's Cumulative Default (1983-2018)										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	0.7%	1.4%	2.0%	2.3%	2.5%	2.6%	2.8%	2.9%	3.1%	3.2%
B2	1.0%	2.1%	2.7%	3.0%	3.1%	3.2%	3.3%	3.4%	3.4%	3.5%
B3	1.6%	2.9%	3.6%	4.0%	4.2%	4.1%	4.2%	4.2%	4.4%	4.4%

(1) Moody's Annual default study: Defaults will rise modestly in 2019 amid higher volatility, dated February 1, 2019 (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1156859)

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Stress Testing Methodology: Default Assumptions (cont'd.)

Below is the default vector for the 'B' rating category in Scenario (C) that includes a one standard deviation stress, used in the CMIAO analysis

4

CMIAO Cumulative Default (1970-2009) + 1 Std Dev										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	4.7%	10.7%	16.4%	21.1%	25.3%	28.8%	32.1%	35.2%	38.3%	40.9%
B2	7.1%	15.6%	22.7%	28.3%	32.0%	35.2%	37.7%	40.0%	42.7%	45.3%
B3	11.5%	21.7%	30.4%	36.8%	41.5%	45.2%	48.1%	51.1%	54.1%	56.5%

We recreated the Scenario (C) vector using the Moody's vector for the period 1983-2018 and added one standard deviation per CMIAO's methodology

5

Moody's Cumulative Default (1983 - 2018) + 1 Std Dev										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	3.9%	9.4%	14.6%	19.2%	23.4%	26.8%	30.2%	33.0%	35.6%	37.4%
B2	5.9%	13.6%	20.2%	25.7%	29.6%	32.8%	35.4%	37.5%	39.7%	41.4%
B3	9.6%	18.9%	27.1%	33.5%	38.3%	42.2%	45.2%	47.9%	50.2%	51.7%

The table below shows the difference between (1) the default vector in Scenario (C) with the one standard deviation and (2) the Moody's default vector for the period 1983-2018 with one standard deviation. The cumulative default rates are consistently overstated

4 - 5

CMIAO Cumulative Default (1970-2009) + 1 Std Dev versus Moody's Cumulative Default (1983-2018) +1 Std Dev										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	0.8%	1.3%	1.8%	1.9%	1.9%	2.0%	1.9%	2.2%	2.7%	3.5%
B2	1.2%	2.0%	2.5%	2.6%	2.4%	2.4%	2.3%	2.5%	3.0%	3.9%
B3	1.9%	2.8%	3.3%	3.3%	3.2%	3.0%	2.9%	3.2%	3.9%	4.8%

Stress Testing Methodology: Recovery Assumptions

- The CMIAO's base case recovery assumption is 64%, representing first lien bank loan recovery rates (based on trading prices as proxy) through multiple credit cycles, which is already much lower than recently observed first lien bank loan recoveries at ~77% (2018 weighted average recoveries)
- The additional stresses applied to Scenarios (B) and (C) using a stepdown to **unsecured** bank loan recovery rates (40%) is not reflective of the senior secured nature of first lien bank loans
  - **The stress recovery assumption of 40%, which reflects unsecured bank debt, does not reflect the reality of CLO portfolios**
    - CLOs (secured by broadly syndicated loans) have strict concentration limits that require the portfolio to contain at least 90% senior **secured first lien** bank loans
  - Senior secured bank loan is very different than unsecured bank debt. In an event of a default, senior secured lenders have control and priority claim over the underlying collateral, while unsecured lenders are not paid until the secured debt has been fully repaid
    - 40% is an implausible stress number – 64% is already quite conservative given the data – and **a further 24 percentage point downward stress on an already conservative number is meant to lead to "break" scenarios in which very high losses are output from the model, regardless of the actual definition of the asset**
  - Average historical recovery rates (measured by trading prices)(1)

	Issuer-weighted recoveries			Volume-weighted recoveries		
Priority Position	2018	2017	1983-2018	2018	2017	1983-2018
1st Lien Bank Loan	71.07%	69.19%	67.19%	77.67%	74.72%	64.07%
2nd Lien Bank Loan	54.96%	17.87%	32.27%	33.45%	30.29%	28.68%
Sr. Unsecured Bank Loan	41.93%	9.00%	45.75%	42.26%	9.00%	40.29%
1st Lien Bond	56.75%	65.91%	53.99%	68.75%	67.09%	55.23%
2nd Lien Bond	35.16%	52.75%	44.07%	43.62%	36.61%	43.74%
Sr. Unsecured Bond	48.75%	55.07%	38.15%	42.47%	41.03%	33.87%
Sr. Subordinated Bond	45.63%	38.00%	31.08%	25.60%	50.62%	26.33%
Subordinated Bond	n.a.	50.20%	31.98%	n.a.	68.34%	27.52%
Jr. Subordinated Bond	n.a.	27.17%	23.67%	n.a.	44.99%	26.78%

(1) Moody's Annual default study: Defaults will rise modestly in 2019 amid higher volatility, dated February 1, 2019 (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1156859)

Stress Testing Methodology: Recovery Assumptions (cont'd.)

- Other rating agencies and arrangers have published similar reports stressing CLO default and recovery rates, but no other research assumes across the board recoveries at a level as low as 40%
  - S&P published a CLO stress analysis[(1)] in November 2019 in which all currently rated 'CCC' obligors default, recovering 45%, and all currently rated 'B-' obligors are downgraded to 'CCC' with price declining to 60%
  - In J.P. Morgan's breakeven analysis from fall 2018 [(2)], they stress recovery rates down to a 40-60% range to generate a principal loss in the BB tranche and note that these scenarios are severe as "at the peak of the Great Recession, the first-lien loan recovery rate dropped to average 48.33 cents … rose to 71 cents in 2010"
  - Morgan Stanley's breakeven default rate analysis [(3)] in September 2019 uses 60% recovery rates in CLO tranche stresses
- Moody's discussed in a report[(4)] published in August 2018 that it expect loan recoveries to decline in the next downturn due to lower subordinated debt cushion
  - However, Moody's projects a recovery of 61% for first lien bank loans in the next downturn, still much higher than the 40% **unsecured** recovery rate used in the CMIAO stress analysis
- Furthermore, since CLOs do not have any market value triggers that would require the sale of a loan upon default, ultimate recovery rates should be taken into consideration, as CLO managers can decide the best way to optimize recovery
- The table below from a Moody's report[(5)] shows that ultimate recovery rates are often much higher than the recovery implied by trading price (on previous page) at the time of default

	Default Year		
Priority Position	2018	2017	1987-2018
Loans	85.0%	84.3%	80.3%
Senior Secured Bonds	55.0%	65.7%	62.2%
Senior Unsecured Bonds	35.5%	58.3%	47.7%
Subordinated Bonds	n.a.	62.9%	28.0%

(1) "To B- or Not to B-? A CLO Scenario Analysis in Three Acts", dated November 26, 3019, (https://www.spglobal.com/ratings/en/research/articles/191126-clo-spotlight-to-b-or-not-to-b-a-clo-scenario-analysis-in-three-acts-11228414)
(2) "The Late Cycle Show: ABS East CLO Feedback", dated September 28, 2018, (https://markets.jpmorgan.com/#research.article_page&action=open&doc=GPS-2787208-0)
(3) "A Default! A Default! Our Breakeven Analysis for a Default!", dated September 19, 2019, (https://ny.matrix.ms.com/eqr/article/webapp/64c4e444-bec7-11e9-8328-83238dcc6754?ch=rpint&sch=ar)
(4) Moody's Convergence of bonds and loans sets stage for worse recoveries in the next downtown, dated August 16, 2018 (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1128748)
(5) Moody's Annual default study: Defaults will rise modestly in 2019 amid higher volatility, dated February 1, 2019 (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1156859)

Stress Testing Results: Sample Set Bias and Methodology

- The CMIAO report goes into great detail on its "stress testing" of CLOs, but its discussion on combo notes is very short and lacks detail
  - Sample set
    - The report claims to have conducted stress testing on only $1B of combo notes, which creates a small sample bias
    - The sample set used for the analysis was undisclosed (unclear if recent or seasoned deals) and it is therefore impossible to replicate the tests
    - The compositions of the combo notes were unknown (the amount of rated tranches and CLO equity in the combo?)
  - Methodology
    - It is unclear how principal loss is computed for combo notes in the CMIAO's analysis. Combo notes are amortizing structures so a methodology to calculate losses should be defined and not simply assumed

3. Additional Information

CLO Structural Improvements

- All of the defaults on both Moody's and S&P-rated CLO tranches occurred in transactions issued before the financial crisis
- Given the structural improvements on "post-crisis" CLOs, we strongly believe that CLO default rates going forward will be even lower than the historical life-to-date levels
- "Post-crisis" structures have more subordination with credit support effectively improving by one rating level since the crisis
- As an example, below is a comparison of certain concentration limitations of two Ares-managed CLOs issued pre-crisis versus post-crisis, as well as a table showing the improvement in credit enhancement levels between "pre-crisis" and "post-crisis" CLOs

Ares Concentration Limitations	Pre-Crisis	Post-Crisis
Deal	Ares X	Ares XLVI
Closing Date	Sept 2005	Jan 2018
Senior Secured Loans	Min 80%	Min 96%
Senior Unsecured and Subordinated Debt Securities	Max 10%	Max 0%
Structured Finance Securities	Max 5%	Max 0%
Synthetic Securities	Max 20%	Max 0%
Finance Leases	Max 5%	Max 0%

Credit Support (1)		
Original Rating	Pre-Crisis	Post-Crisis
AAA	25.0%	35.1%
AA	18.6%	23.6%
A	12.8%	17.3%
BBB	8.1%	11.9%
BB	5.6%	7.8%

(1) Wells Fargo Securities "FAQ on CLOs and Leveraged Loans", dated January 31, 2019. Credit support is defined as the amount of capital below a given tranche in the transaction

CLO Ratings

- Rating agencies rate CLO tranches much more conservatively than the actual default experience would imply
- We compare the actual life-to-date CLO impairment rates (for period 1993-2018) from a Moody's research report[1] to the idealized default rate over a 10-year horizon from Moody's rating methodology[2]
- The implied ratings based on actual life-to-date impairments are much higher than the ratings issued by Moody's. For example, 'Baa' to 'B' CLO tranches should be rated 'A'
- S&P-rated CLO tranches[3] show a similar finding, where the lower mezzanine tranches ('BBB', 'BB', and 'B') should be rated two rating categories higher based on actual default experience

Rating Methodology

Rating Factor	Rating	Moody's Idealized Default Rates (10y Horizon)
1	Aaa	0.0100%
10	Aa1	0.1000%
20	Aa2	0.2000%
40	Aa3	0.4000%
70	A1	0.7000%
120	A2	1.2000%
180	A3	1.8000%
260	Baa1	2.6000%
360	Baa2	3.6000%
610	Baa3	6.1000%
940	Ba1	9.4000%
1350	Ba2	13.5000%
1766	Ba3	17.6600%
2220	B1	22.2000%
2720	B2	27.2000%
3490	B3	34.9000%
4770	Caa1	47.7000%
6500	Caa2	65.0000%
8070	Caa3	80.7000%

Moody's US CLO Historical Experience

Original CLO Rating	Life-to-Date Impairment Rate 1993-2018	Implied Rating based on Rating Methodology	Current NAIC Rating	Implied NAIC Rating
Aaa	0.00%	Aaa	1	1
Aa	0.00%	Aaa	1	1
A	0.06%	Aa1	1	1
Baa	1.34%	A3	2	1
Ba	1.76%	A3	3	1
B	1.12%	A2	4	1

S&P US CLO Historical Experience

Original CLO Rating	Life-to-Date Default Rate 1994-2013	Implied Rating based on Rating Methodology	Current NAIC Rating	Implied NAIC Rating
AAA	0.00%	Aaa	1	1
AA	0.00%	Aaa	1	1
A	0.45%	A1	1	1
BBB	0.28%	Aa3	2	1
BB	1.66%	A2	3	1
B	2.61%	Baa1	4	2

(1) Moody's Impairment and Loss Rates of Global CLO: 1993-2018, dated May 17, 2019, (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_1164579)
(2) Moody's Global Approach to Rating Collateralized Loan Obligations, dated September 28, 2015 (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF405477)
(3) S&P Twenty Years Strong: A Look Back at US CLO Ratings Performance from 1994 through 2013, dated January 31, 2014 (https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/8447971)

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CLO Safety

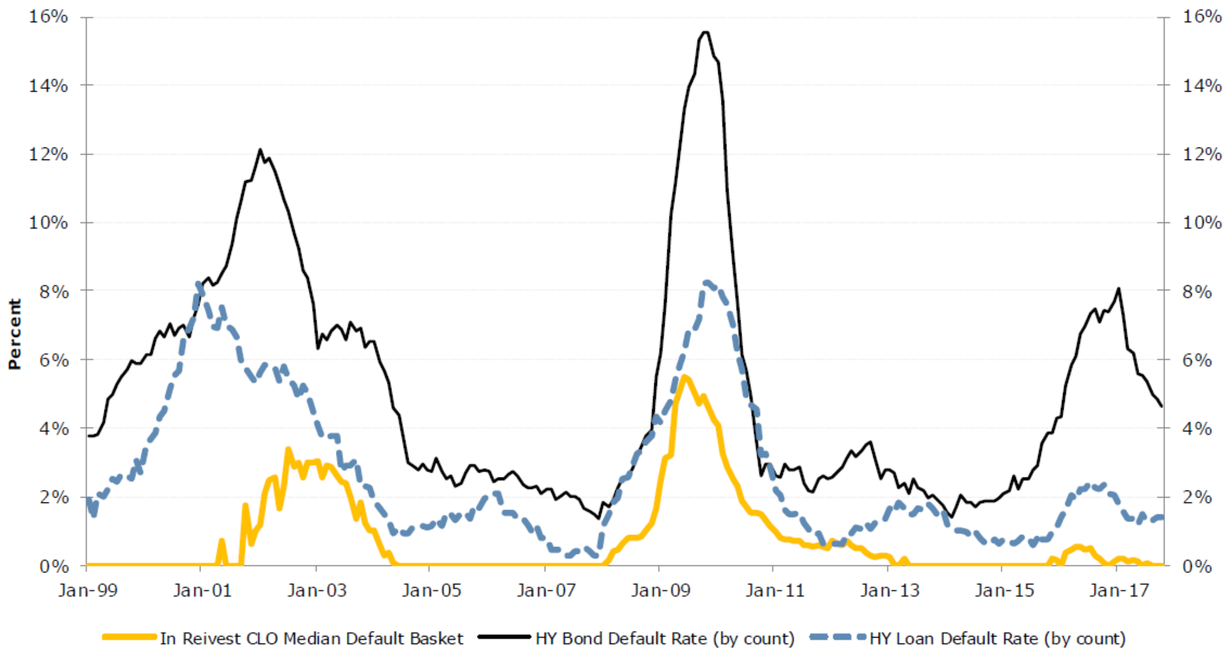
- CLOs benefit from a better structure and credit enhancement as compared to investment grade bonds

Features	CLO	Investment Grade Single Names
Senior Secured Risk	✓	✗
Diverse Portfolios of Assets	✓	✗
Structural Protections	✓	✗
Cycle-Tested	✓	✗
Non Mark-to-Market Structure	✓	✗
Locked-in Term Financing	✓	✗

- CLOs trade wide due to a complexity premium, which SBL believes it can mitigate through its market knowledge and experience

Historical CLO Default Performance

- Wells Fargo published a report[1] in November 2017, also showing that CLOs experienced lower than market default rates even throughout the credit crisis due to active management, which allowed CLO portfolios to perform
- During the credit crisis, CLO holdings of defaulted assets peaked at just below 6% in Q2 2009, despite the loan market default rate continuing to rise until the cyclical peak in Q4 2009

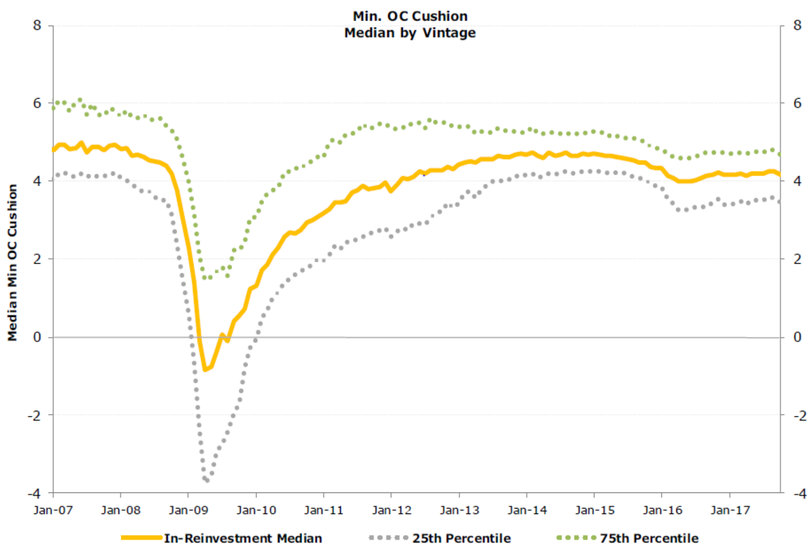


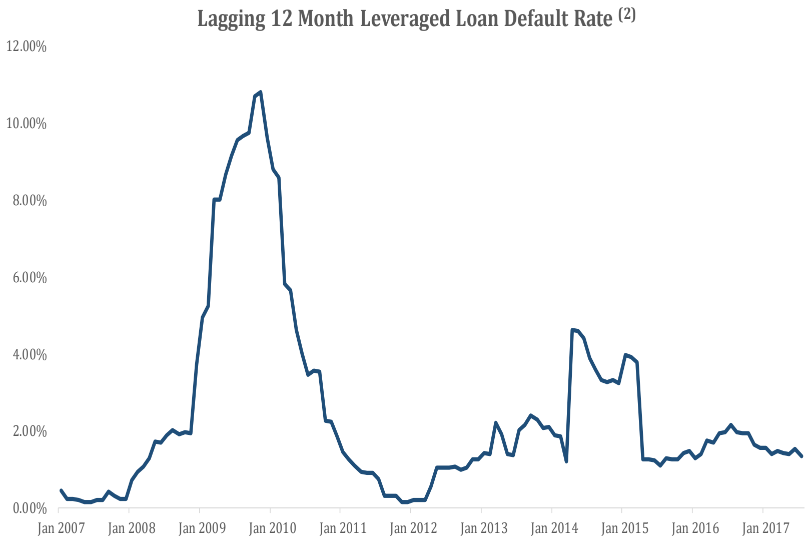
Source: LCD, Wells Fargo Securities

(1) "CLO's: How bad was it? CLO Market After Action Review: Part 1", dated November 29, 2017, by David Preston, Geoff Horton and Mackenzie Miller

Historical Performance on Equity Tranches (cont'd.)

- The research report[1] shows that at the peak of the financial crisis in the first half of 2009, over 50% of U.S. CLOs had equity distributions cut off and diverted to pay down CLO debt tranches (i.e. failure of an overcollateralization test[3]), and the average period that equity distributions were cut off was approximately two quarters
- However, even at the peak of the crisis, the top quartile of deals still had over two points of overcollateralization cushion, and the equity tranche continued to receive distributions throughout





(1) "CLO's: How bad was it? CLO Market After Action Review: Part 1", dated November 29, 2017, by David Preston, Geoff Horton and Mackenzie Miller
(2) Source: S&P LCD
(3) Overcollateralization test measures the amount of asset coverage over CLO liabilities: a failure would mean that overcollateralization declined below the test level

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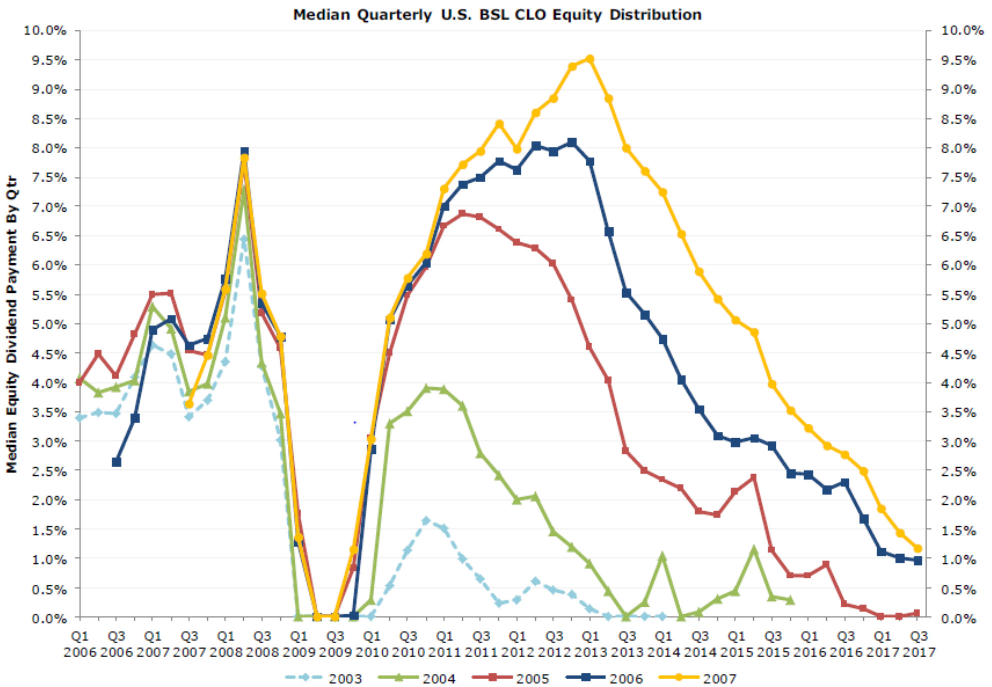
Historical Performance on Equity Tranches (cont'd.)

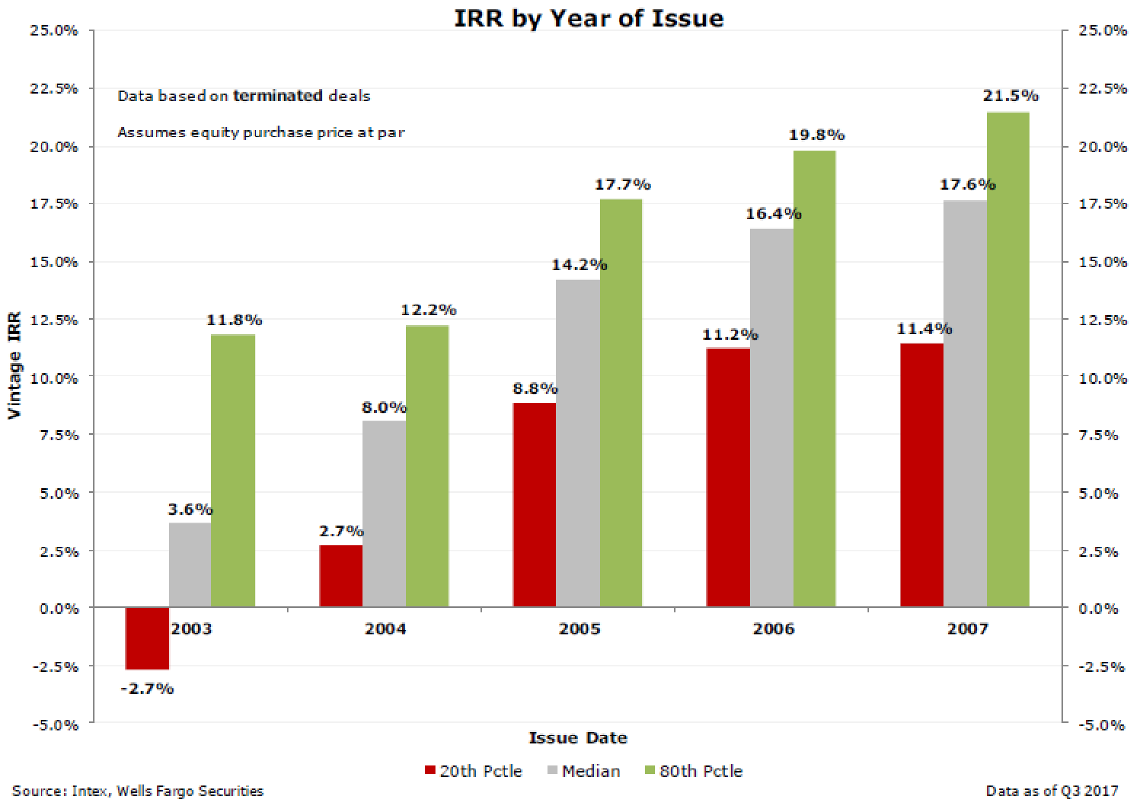
- Wells Fargo[1] also shows the median equity distributions, by vintage, for pre-crisis U.S. CLOs before, during and after the crisis
- Average CLO equity distributions were for only a couple of quarters in 2009. However, equity distributions recovered quickly as managers were able to take advantage of wider spreads and cheaper assets



(1) "CLO's: How bad was it? CLO Market After Action Review: Part 1", dated November 29, 2017, by David Preston, Geoff Horton and Mackenzie Miller

Historical Performance on Equity Tranches (cont'd.)

- All pre-crisis CLO equity investments had a positive IRR (except for the lowest 20th percentile of the 2003 vintage), meaning that all the equity investments received cumulative distributions that were in excess of the initial principal amount(1)



(1) "CLO's: How bad was it? CLO Market After Action Review: Part 1", dated November 29, 2017, by David Preston, Geoff Horton and Mackenzie Miller

Third Party Research

Bank of America Research Report excerpt

- Appendix II
- Expresses many of the same misgivings about the CMIAO reports

Appendix II

NAIC's stress tests of insurers' CLO exposure

In December 2019, the National Association of Insurance Commissioners (NAIC) put out a report[2] outlining the findings of its stress tests of US insurers' CLO exposure. NAIC generated stress tests showed that losses "only reach BBB rated tranches even under the worst case scenario" but "reached AA-rated securities" for "atypical" CLO tranches. We think the NAIC's combination of (1) high default assumptions, (2) excessively low stressed recovery rates, and (3) the lack of credit to CLO management function create an unrealistically stressful analysis that produced losses surpassing those seen through the Great Financial Crisis (GFC), which we already consider a high water mark for the next potential cycle turn. The conclusions on CLO combination notes also drew some eyebrows, as NAIC-projected losses appear disproportionately large when pitched against historical CLO equity performance.

Background of the study

The NAIC cited recent regulatory interest in leveraged loans and CLOs as motivation for the study, while we also believe the rising participation from insurance companies in the asset class put them on the NAIC's radar. In another report[3] published by NAIC in June 2019 titled "U.S. Insurance Industry's Exposure to Collateralized Loan Obligations as of Year-End 2018," it was estimated that US insurers held approximately $122bn of CLOs in book/adjusted carrying value by YE 2018.

The NAIC stress tests were run on three simulations based on two sets of defaults and recovery assumptions. The test scenarios are outlined as follows:

Table 1: NAIC stress test scenarios

Scenario	Default Rate	Recovery Rate
A	Historical	Historical (snr sec loan = 64%)
B	Historical	Stepdown (snr sec loan = 40%)
C	Historical + 1σ (std. dev)	Stepdown (snr sec loan = 40%)

Source: NAIC

In this report, the NAIC constructed their own default vectors based on Moody's historical corporate default data. To stress the bonds even further, the agency added one standard deviation to the "historical" default vectors in the most stringent test scenario (Scenario C, Table 1). The historical 1st lien loan recovery rate was assumed to be 64%, which is borrowed from Moody's estimation of 1st lien loans' $-weighted recovery based on trading prices. The agency then applies "stepdown" recovery assumptions to Scenario B & C, assuming senior secured loans will recover similar to unsecured bank loans in the next downturn (40%). The stress tests do not take into account the role of CLO managers, a commonly observed feature in most CLO stress test models due to the modeling complexities of such tasks – in particular, the ability to buy and sell distressed assets in order to build par.

Projected losses CLO debt tranches appear out of range with historical data

After applying the aforementioned assumptions to a sample of $96bn of "normal" CLOs held by insurance companies by YE18, the NAIC found that losses may reach up to BBs in the most benign scenario (A) while potentially impacting even IG-rated BBBs in the most severe set of assumptions (C). Most striking to us is the loss projections that the NAIC arrived at for lower mezzanine CLOs, which suggest that half to almost all principal invested in CLO BB-Bs will be wiped out in Scenario B and C (Table 2).

[2] NAIC, *Collateralized Loan Obligations – Stress Testing U.S. Insurers' Year-End 2018 Exposure,* Dec 2019

[3] NAIC, *U.S. Insurance Industry's Exposure to Collateralized Loan Obligations as of Year-End 2018,* June 2019

Table 2: Projected principal losses on "normal" CLO tranches

Lowest Rating	Mapped Exposure	Scenario A Loss	Loss %	Scenario B Loss	Loss %	Scenario C Loss	Loss %
AAA	43,729	-	0.0%	-	0.0%	-	0.0%
AA	22,701	-	0.0%	-	0.0%	-	0.0%
A	15,204	-	0.0%	-	0.0%	-	0.0%
BBB	11,525	-	0.0%	-	0.0%	1,942	16.9%
BB	2,465	7	0.3%	1,126	45.7%	2,344	95.1%
B	174	74	42.5%	169	97.0%	171	98.6%
CCC	11	10	89.1%	11	100.0%	11	100.0%
Total	95,808	91	0.1%	1,305	1.4%	4,469	4.7%

Source: NAIC

Table 3: Projected principal & interest losses on "normal" CLO tranches

Lowest Rating	Mapped Exposure	Scenario A Loss	Loss %	Scenario B Loss	Loss %	Scenario C Loss	Loss %
AAA	43,768	-	0.0%	-	0.0%	-	0.0%
AA	22,684	-	0.0%	-	0.0%	-	0.0%
A	15,202	-	0.0%	-	0.0%	-	0.0%
BBB	11,525	-	0.0%	-	0.0%	3,040	26.4%
BB	2,487	12	0.5%	1,612	64.8%	3,584	144.1%
B	174	132	75.9%	265	152.6%	275	158.0%
CCC	11	11	101.8%	13	116.3%	13	118.6%
Total	95,852	155	0.2%	1,890	2.0%	6,912	7.2%

Source: NAIC

These numbers were much higher than historical cumulative losses on US CLOs, as provided in a 2019 Moody's report[4] (Table 4). According to Moody's estimations, 10-year cumulative losses totaled less than 12% among 358 CLO tranches rated single-B at issuance in the period from 1993 to 2018, which, of course, includes the GFC. That said, Moody's attributed the jump in estimated loss rates among single-B CLOs from year 5 to year 6 (2% to 12%) to the small universe outstanding beyond that point, as the majority of B-rated CLOs were issued after 2014. Meanwhile, BB CLO 10-year cumulative losses totaled just below 4% in a sample of 1477 bonds.

Table 4: US CLOs, Estimated ,multi-year cumulative loss rates by original rating, 1993-2018

	Cohort size (#)	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
Aaa	3,833	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Aa	1,961	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
A	1,816	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Baa	1,791	0.0%	0.0%	0.0%	0.3%	0.3%	0.3%	0.4%	0.9%	1.2%	1.2%
Ba	1,477	0.0%	0.0%	0.3%	0.6%	0.8%	1.0%	1.0%	2.0%	2.8%	4.0%
B	358	0.0%	0.0%	1.7%	1.7%	1.7%	11.8%	11.8%	11.8%	11.8%	11.8%
Investment-Grade	9,401	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.2%	0.3%	0.3%
Speculative-Grade	1,836	0.0%	0.0%	0.5%	0.8%	0.9%	1.3%	1.3%	2.3%	3.1%	4.3%
All	11,237	0.0%	0.0%	0.1%	0.2%	0.2%	0.3%	0.3%	0.5%	0.7%	0.9%

Source: Moody's

In the same report, Moody's also stated that no CLOs rated by the agency since 2009 have been impaired to date, implying all losses were associated with CLO 1.0s. All else equal, CLO 2.0s should in theory see lower losses than their pre-crisis counterparts due to higher structural subordination (Table 5). Therefore, the 42% loss on single-B CLOs projected by NAIC even in their most benign stress scenario (A) seems unrealistic in our opinion.

Table 5: Volume-weighted credit support for BSL CLO 1.0s and 2.0s

	B	BB	BBB	A	AA	AAA
CLO 1.0 (2003-2009)	9%	9%	12%	16%	22%	28%
CLO 2.0 (2010+)	10%	10%	15%	20%	27%	38%

Source: BofA Global Research

[4] Moody's, *Impairment and loss rates of global CLOs: 1993-2018*, May 2019

Default assumptions

We believe such distinct variations in NAIC projected losses and historical figures for US CLOs stem from the agency's model inputs and thus set out to further understand the underlying assumptions. In their methodology, the NAIC employed a cohort-averaging approach to derive the historical default vectors. Specifically, the agency chose to average Moody's default vectors[5] only from annual cohorts where at least 10 years of history was available, weighted by issuer count. This limits the sample to loans issued between 1970 and 2009, which in our opinion represents a mismatch with the current collateral and structural profile of US CLOs where the overwhelming majority of underlying loans are issued post-crisis.

Comparing the NAIC-generated default vectors (Table 6) with Moody's own averaged cumulative default vectors (Table 7) which consist of data from 1983 to 2018, the difference in default assumptions range from as little as 1% for Ba1-rated issuers to almost 12% for those rated Ca-C. While the average concentration of loans rated Caa and below by Moody's among US CLOs still hover around 4%, we estimate that loans rated B1 to B3 made up almost 75% of rated CLO collateral ex. defaults as of YE19, making assumptions on these rating buckets most instrumental in driving projected losses. This would translate to default assumptions on issuers rated B2 to Caa, as senior secured loans are often rated one notch higher than their respective corporate family rating.

Table 6: NAIC's "historical" default vectors by issuer rating and years into seasoning, 1970-2009

	1	2	3	4	5	6	7	8	9	10
Ba1	0.6%	1.8%	3.1%	4.4%	5.8%	7.2%	8.2%	9.0%	9.8%	10.7%
Ba2	1.0%	2.4%	3.9%	5.4%	6.8%	8.0%	9.1%	10.4%	11.8%	13.4%
Ba3	1.8%	4.8%	8.0%	11.6%	14.6%	17.5%	20.0%	22.4%	24.7%	26.7%
B1	2.7%	6.7%	10.9%	14.7%	18.5%	21.9%	25.3%	28.2%	30.8%	32.9%
B2	4.0%	9.8%	15.1%	19.7%	23.4%	26.8%	29.7%	32.1%	34.3%	36.4%
B3	6.5%	13.6%	20.2%	25.7%	30.4%	34.4%	37.9%	40.9%	43.5%	45.5%
Caa	12.8%	23.1%	30.9%	37.1%	41.7%	45.4%	48.2%	51.0%	53.6%	55.8%
Ca-C	49.8%	61.5%	67.6%	70.8%	71.5%	71.5%	72.5%	73.4%	73.4%	73.4%

Source: NAIC

Table 7: Moody's average cumulative issuer-weighted default rates by issuer rating, 1983-2018

	1	2	3	4	5	6	7	8	9	10
Ba1	0.4%	1.4%	2.6%	3.8%	5.1%	6.3%	7.2%	7.9%	8.7%	9.5%
Ba2	0.7%	1.9%	3.3%	4.7%	6.0%	7.0%	8.0%	9.2%	10.5%	11.8%
Ba3	1.4%	3.8%	6.8%	10.1%	12.7%	15.3%	17.6%	19.8%	21.8%	23.7%
B1	2.0%	5.3%	8.9%	12.4%	16.0%	19.3%	22.5%	25.3%	27.7%	29.7%
B2	3.0%	7.7%	12.4%	16.7%	20.3%	23.6%	26.4%	28.7%	30.9%	32.9%
B3	4.9%	10.7%	16.6%	21.7%	26.3%	30.3%	33.7%	36.7%	39.1%	41.1%
Caa	7.9%	15.3%	21.9%	27.4%	32.2%	36.0%	39.1%	42.1%	45.0%	47.3%
Ca-C	30.7%	40.9%	47.7%	52.4%	55.1%	56.4%	58.9%	60.6%	61.5%	61.5%

Source: Moody's

From Table 6 and Table 7, the discrepancy in NAIC's and Moody's methodology and sampling horizon produced differences of 3.5%, 4.5% and 8.5% for issuers rated B2, B3, and Caa at year 10. We believe the recalculation of such default vectors by NAIC to (1) extend the sample to cover data from 1970 (vs. 1983 as provided by Moody's) and (2) maintain the 10-year data availability in all sampling cohorts is unwarranted as it comes at the expense of recent data points that are more relevant to the population of loans underlying currently outstanding CLOs. Limiting the default sample to just pre-2009 entries also does not account for the structural change in loan documentation over time, where the rise of cov-lite structures give issuers a longer runway to default compared to their pre-crisis counterparts. As such, these default assumptions do not align with our

[5] Moody's, *Annual default study: Defaults will rise modestly in 2019 amid higher volatility*, Feb 2019

view that, due to the rise in cov-lite, the next spike in loan defaults is likely to be shallower compared to the GFC experience.

On another front, since Moody's cohort data that underlies NAIC's calculations were only made available at the broad (letter) rating level (ex: Ba), we believe NAIC's approach of scaling the letter default vectors by historical rating distributions to arrive at alphanumeric default vectors (ex: Ba1, Ba2, Ba3) make the assumptions more prone to errors and are more likely to misrepresent the actual historical default experience of corporate issuers.

For the reasons mentioned above, we prefer Moody's default vectors ('83-'18) to those employed by the NAIC ('70-'09) when running these simulations, especially when the NAIC proceed to employ recovery assumptions that were aggregated over the period from 1983-2018 and not 1970-2009 as we will further examine below.

Recovery assumptions

Recovery assumptions in NAIC's stress tests mostly follow their stress thesis that "the consequences of less stringent underwriting on the underlying bank loan collateral will result in substantially lower recovery rates during the next recession". Both the "historical" and "stepdown" versions of assumed recoveries were based on Moody's historical averages of trading price recovery for 1st lien and senior unsecured bank loans in the period from 1983 to 2018, respectively. The "historical" recovery rate was thus set at 64% for senior secured loans, which seems reasonable and falls into the mid-range of the current market where traders usually price bonds to 60%-70% recovery depending on the manager and portfolio construct.

However, we don't necessarily endorse the use of historical senior unsecured loan recoveries (40%) to reflect future loan recoveries in NAIC's "stepdown" scenarios. Firstly, there were simply not enough senior unsecured loans issued historically to provide a statistically robust dataset. To quote some numbers, the 64% 1st lien bank loan recovery calculation provided by Moody's was backed by 501 issuers ($299bn), while the 40% recovery on senior unsecured loans was supported by only 69 observations ($35bn).

While we acknowledge that the prevalence of cov-lite loans has made it harder for loans to go under and might drag down the quality of pool that eventually default, the comparison between secured and unsecured loan obligations seems to be a stretched effort in factoring in the deterioration in loan documentation over time. If we were made to choose an alternative, historical recoveries on 1st lien bond (secured) seem to better serve NAIC's purpose in carrying out their stress thesis. In the same Moody's report, this volume-weighted recovery was estimated to be around 55% and backed by a sizeable sample of more than 300 issuers totaling almost $150bn in dollar volume, a significantly larger sample than that of senior unsecured loans.

Combo notes on the chopping block, lacking transparency in methodology

After putting "normal" CLO tranches through these tests, NAIC also put tranches with so-called "atypical" payment promises such as equity tranches or combination notes through the ringer. While NAIC did not calculate losses of equity tranches due to the unpredictability of distributed cash flows, they did run the analysis through CLO "combo notes." As a refresher, CLO combo notes are securities that repackage cash flows from existing CLO notes into a single security. While the structure of such bonds may vary, the most common type of combo notes usually combine principal and interest paying notes (usually mezz bonds and an equity piece) into a principal-only note that can have a blended rating higher than some of its respective constituents. As such, the assigned rating is typically rated on a principal-only structure where interest and all principal cash flow from the underlying CLO components are directed towards paying down the principal balance of the combo notes, creating overcollaterization[6]. According to

[6] Morningstar, *Frequently Asked Questions About CLO Combination Notes*, Feb 2019

Morningstar, which rated more than 60 combination notes as of YE18, such notes were predominantly assigned BBB- ratings but have seen ratings as high as single-A.

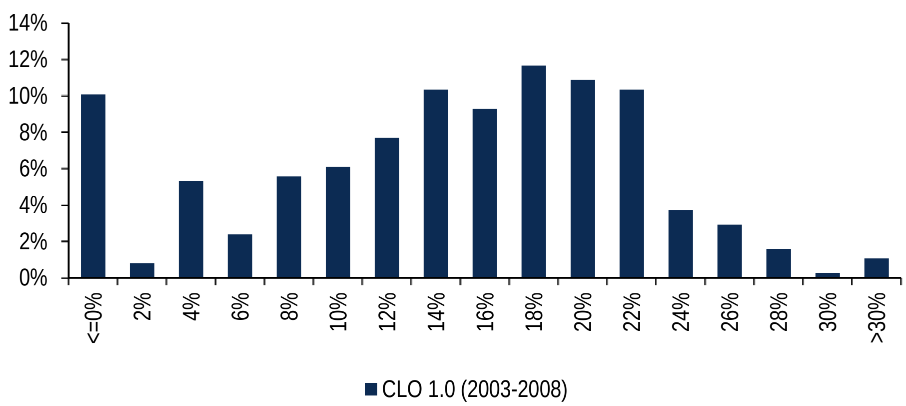
NAIC stress tests claimed that, under their scenarios, principal losses to combo notes can average about 28% in the Scenario A and 30% in Scenario C, mostly driven by halted payments of the equity portion. While these figures look particularly eye-popping, the NAIC provided little transparency on how such losses were actually calculated based on the set of assumptions laid out above, making it hard for us to rebut these findings from a methodology perspective.

That said, we still have several reasons to be skeptical of these results. First of all, the small differential between average losses in Scenario A and C look particularly unusual given the significant step up in assumed defaults (1 standard deviation) and haircut on recovery assumptions (24%).

Second, NAIC disclosed that it was able to map and model only $1bn in “atypical” CLO notes, which include both CLO equity and combo notes. It is unclear what’s the notional amount underlying their findings for CLO combo notes’ stress tests, but given the already small size of this pool of “atypical” notes, we do not believe this to be a fair sample of the CLO combo note universe, many of which are privately placed and vary in structures.

Third, it was unclear whether equity cash flow shutdowns were modeled as a lifetime or temporary event in NAIC’s stress tests. Based on Intex historical data, we saw that the majority of CLO equity tranches that experienced cash flow shutdowns during the Great Financial Crisis eventually resumed paying in 2010-2011. In fact, the majority of CLO 1.0 equity enjoyed double-digit IRRs in our estimation, even with the very conservative assumption that these notes were priced at par. In our sample of 377 equity tranches from 1.0 CLO deals that have paid off, only 10% saw negative IRRs (Chart 1). In reality, many of these deals might not have experienced any time-weighted losses if the notes were acquired significantly below par, which is very often the case.

Chart 1: Distributions of CLO 1.0 equity IRRs for paid off deals, assuming notes are priced at par



Source: BofA Global Research, Intex

Given equity cash flows are used to pay down principal balance on the combo notes, coupled with CLO 1.0 equity’s resilient performance even throughout the GFC, NAIC’s 28%-30% principal losses on CLO combo notes do not seem to be a fair estimation in our view.

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

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group

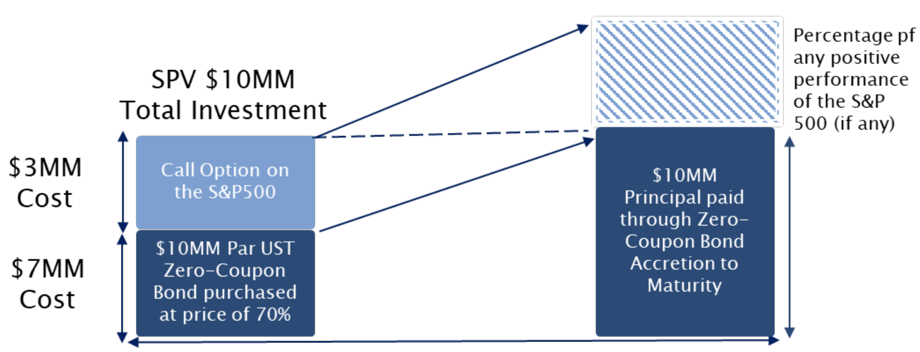
DATE: July 2, 2019

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Update the Definition and Instructions for Principal Protected Notes

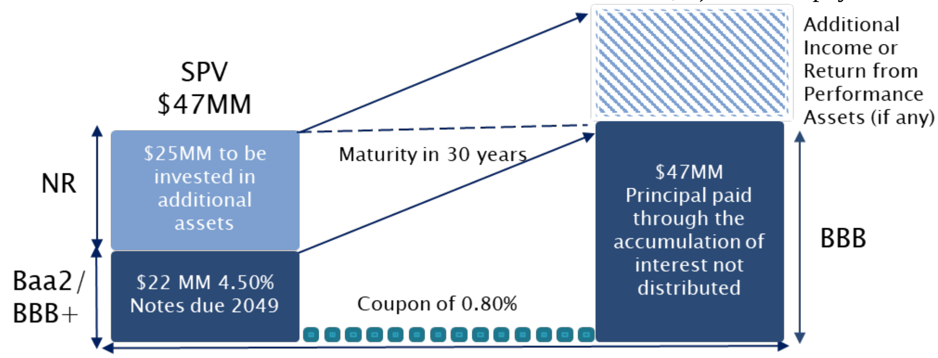
1. **Introduction –** The SVO proposes a substantive amendment to the P&P Manual to update guidance in Part Three under the Procedure Application to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities, Specific Populations of Securities Not Eligible for Filing Exemption. The SVO has become aware of a class of structured securities, known as Principal Protected Notes, that mixes a traditional bond or bonds with additional assets that may possess any characteristic. These additional assets are intended to generate an excess return, we call them the "performance assets;" such as, derivatives, common stock, commodities, equity indices, etc. … essentially any asset. The performance assets may include undisclosed assets and are typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond

2. **Analytical Concern** – The SVO has reviewed a dozen or more of these securities. They share a consistent theme; the external credit rating provider (CRP) rating is based solely on the component dedicated to the repayment of principal and ignores the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1. There are many potential variants of this structure, for simplicity I have included examples of two common forms below. While the transactions details have been changed to maintain confidentiality the examples accurately reflect the risks and assets embedded within these structures.

   a. In this initial example there are only two components: 1) a $10 MM par UST zero-coupon bond sold at discount (ex. $70) from par ($100) that will pay par ($100) at maturity and 2) a return linked to any positive performance of call options on the S&P 500 Index (if the S&P 500 Index has a negative performance, investors will only receive an amount equal to their initial investment). The external rating would be AAA, based solely on the risk of the UST security.



b. In the second example there are multiple components: 1) a $22MM corporate bond paying a fixed coupon (ex. 4.50%) with a stated maturity date (ex 9/30/2049), 2) the corporate bond has two NRSRO ratings (Moody's Baa2, S&P BBB+), 3) the SPV invests $25MM in additional undisclosed and unrated assets, 4) the SPV pays a semi-annual coupon of 0.80%, 5) the excess coupon difference (4.50% - 0.80% = 3.70%) is used to accumulate into the required principal to pay at maturity and 6) a different NRSRO rated the PPN a BBB, again based solely on the corporate bonds that represent less than 50% of the total investment in this example.



In both examples, assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that schedule through financial structuring. Significant risks are being obscured by focusing only risk associated with the repayment of principal. The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche.

3. **Recommendation** –The SVO proposes removing this class of securities from eligibility for Filing Exemption. The SVO has existing methodologies that can applied to assess the overall risk of these structures and, to the extent that the SVO identifies possible affiliated assets, the SVO would alert regulators. The SVO also recommends referring this memorandum to the Statutory Accounting Principles (E) Working Group to consider the treatment of the asset transformations described above.

4. **Proposed Amendment** – The proposed amendment is shown below in red-underline.

Part Three SVO Procedures and Methodology for Production of NAIC Designations

PROCEDURE APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL) RATING SECURITIES

…

Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:

…

- Principal Protected Notes (PPN) – PPN (sometime called "Principal Protected Securities," "Principal Protected Loans," or "Combo Notes") are a type of structured security where a portion of the underlying assets are dedicated to ensure the repayment of principal at maturity or a third party may guarantee the repayment of principal at maturity. The remaining assets in the structure, the performance assets, are intended to generate additional returns and may be of a type (ex. derivatives, equities, commodities, non-CRP rated debt, loans, funds, private equity, real estate, affiliated, undisclosed, etc.) that would not be eligible for reporting on Schedule D. Investments in PPNs must be submitted to the SVO for analysis.

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September 20, 2019

Submitted electronically to ctherriault@naic.org and dgenaorosado@naic.org

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Dear Mr. Fry:

We appreciate the opportunity to comment on the Valuation of Securities Task Force (the "Task Force") exposure regarding the 'Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update the Definition and Instructions for Principal Protected Notes' (the "Exposure"). We support the Task Force's and SVO's objective to provide solutions to investment-related regulatory issues for existing or anticipated investments. We recommend however, that:

- the proposed definition of PPNs be made more clear and less encompassing;
- the Task Force consider the accounting treatment's impact to capital as well as the proposed changes' impact on required capital;
- the Task Force provide more transparency into the process that would be utilized to assign ratings for PPN;
- the Task Force consider potential materiality of exposure to the change and the timing of implementation.

Commentary in the Introduction Section

The Exposure states:

> These additional assets are intended to generate an excess return, we call them the "performance assets;" such as, derivatives, common stock, commodities, equity indices, etc. … essentially any asset. The performance assets may include undisclosed assets and are typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond.
>
> The SVO has reviewed a dozen or more of these securities. They share a consistent theme; the external credit rating provider (CRP) rating is based solely on the component dedicated to the repayment of principal and ignores the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1.

Based upon the language above, it appears the Task Force has two primary concerns:

- **Concern 1**: Schedule D structured securities whose return is supported by assets not eligible for Schedule D reporting; and
- **Concern 2**: Ratings that reflect the risk of loss of principal and a small coupon, but do not reflect the risk of loss of potential additional returns.

Concern 1

An investment is reported on schedule D, Part 1 through: *SSAP No. 26R - Bonds* ("26R") or *SSAP No. 43R - Loan-Backed and Structured Securities* ("43R").

- 26R exists for investments that have a creditor relationship, whereby there is a fixed schedule for one or more future payments. Essentially, 26R investments have 1) principal amount due and 2) interest amount due.
- 43R exists for investments that have payment of interest and/or principal based upon payments received by the issuer from underlying assets.

Neither 43R, nor to our knowledge, state investment laws or the NAIC model investment law, require the underlying assets to be a 26R eligible asset. Otherwise stated, 43R does not prohibit underlying assets that would otherwise be ineligible for schedule D reporting under 26R. If such a requirement existed, we believe 43R would have less relevance. 43R allows for income generating investments that support insurance company liabilities and asset liability matching ("ALM") core to an insurance company's operations.

Additionally, we believe concerns with certain investments under 43R are already actively addressed by the Statutory Accounting Principles Working Group ("SAPWG") through the following:

- adoption of changes to SSAPs 2R, 26R, 43R, and 86 that require structured notes to be accounted for as derivatives; and
- exposure of changes to 43R to exclude structures with underlying equity interests from the scope of the statement.

Concern 2

We agree with the Exposure that the CRP rating of a PPN is typically directionally consistent (*e.g.*, typically equivalent to +/- 1 notch) with the rating of the component dedicated to the repayment of principal and coupon (*e.g.*, the rating on the underlying corporate bond), and largely ignores the risk and return of the performance asset.

The reason for the rating equivalence is very important, but not mentioned in the Exposure. The reason the ratings are equivalent is that the contractual terms of the PPN (typically repayment of principal plus a small coupon, say 1%) are fully satisfied by the component dedicated to the repayment of principal and coupon. It is logical and definitionally consistent that since 100% of the contractual terms of the PPN are satisfied by, say a BBB-rated corporate bond, that the rating of the PPN would be BBB. Indeed, the risk asset(s) can immediately go to zero and as long as the BBB-rated corporate asset satisfies its principal and interest payments, the insurance company will get all of its investment back plus the small coupon. Additionally, and very importantly, an accounting impairment, which is an immediate reduction to surplus, would likely occur in this situation.[1]

[1] In 2006, the Task Force raised concern that the carry value of a PPN would not represent the amount available to meet current and future obligations of the insurance company if the underlying risk asset(s) was not performing, as the market value of such investment would likely be less than the principal amount. This was because 43R, at that time, only required the use of undiscounted cash flows for assessment of impairment. Accordingly, as long as the "safe" asset(s) was

A separate Task Force presentation delivered to the Task Force at the NAIC's 2019 Summer National Meeting entitled "Bespoke Securities" stated the SVO would rate a NAIC 1 PPN as a NAIC 5.[2] At an 800% ACL RBC level (representative of the level of capital that many insurers hold and before covariance, taxes, or concentration), an insurance company holds 1.6% capital for a NAIC 1 investment and 89.24% capital for a NAIC 5 investment. The proposed change in rating represents a 5,600% increase in required capital for an investment whose contractual terms are 100% satisfied by an A-rated or better asset. This appears very punitive as to an asset on which an insurer is still expected to recover principal and coupon in an adverse business, financial, or economic condition, doubly so considering an impairment through surplus would typically be recognized when the additional asset(s) is not performing.

In short, we believe that the ability of PPNs to satisfy current and future obligations is appropriately managed through the combination of 1) the CRP rating and 2) use of discounted cash flows to assess impairment.

Commentary in the Analytical Section

The Exposure states:

In both examples, assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that schedule through financial structuring. Significant risks are being obscured by focusing only risk associated with the repayment of principal. The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche.

Regarding "*Significant risks are being obscured by focusing only risk associated with the repayment of principal*," we believe the return of principal is a significant risk in and of itself. We acknowledge that the potential for additional return above the stated coupon may not be rated; however, as noted above, statutory accounting principles exist to regulate income recognition and carry value. Furthermore, we would note that 10-year Investment Grade Public Corporate Bonds were issued in September 2019 with coupons as low as 2.20%, with no potential for additional income. An investor could also purchase a NAIC 1 PPN with a 1% contractual coupon, but have the potential and expectation for meaningful additional returns. The NRSRO ratings suggest that both investments have the same likelihood to return contractual payments; however, the PPN could provide additional returns, potentially well above the 2.20% coupon. Additionally, statutory accounting would typically require the PPN to be impaired when the investor is not expected to recover the originally projected cash flows

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performing, future undiscounted cash flows would always support the principal amount, and there would be no impairment even though the risk asset(s) was not performing.

The Task Force referred its concern to the SAPWG, which resulted in substantive revisions to 43R that required the use of discounted cash flows using the original book yield to assess impairment. Accordingly, if the risk asset(s) is (are) not performing, there are less future cash flows, which typically results in impairment. This revision resulted in close alignment of the carry value of PPNs with the amount that would be available to meet current and future obligations.

[2] The analytical details behind the rating were not disclosed; however, an NAIC 5 is equivalent to a S&P CCC rating. S&P defines a CCC rating as one that is "currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitments on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitments on the obligation."

(1% plus estimate of additional returns); however, the corporate bond would only be impaired when the investor does not expect to recover principal and coupon (2.20% in this example).

Regarding "*The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche*," we believe statutory accounting principles governing affiliated transactions ameliorate these concerns, particularly with the principle application of *SSAP No. 25—Affiliates and Other Related Parties*. As such, a PPN would have to be designated as affiliated if the return of the PPN is predominately provided by affiliated investments. Additionally, SSAP No. 25 requires that affiliated investments be arm's-length, fair, reasonable, and economic.

Proposed Amendment

The proposed amendment is as follows:

Principal Protected Notes (PPN) – PPN (sometime called "Principal Protected Securities," "Principal Protected Loans," or "Combo Notes") are a type of structured security where a portion of the underlying assets are dedicated to ensure the repayment of principal at maturity or a third party may guarantee the repayment of principal at maturity. The remaining assets in the structure, the performance assets, are intended to generate additional returns and may be of a type (ex. derivatives, equities, commodities, non-CRP rated debt, loans, funds, private equity, real estate, affiliated, undisclosed, etc.) that would not be eligible for reporting on Schedule D.

We would urge you to consider revisions to the following proposed amendment defining PPN and have provided suggested language below. We believe this revised definition would provide the industry with the clarity and specificity which will result in consistent implementation of the exposure while at the same time capturing both examples provided in the body of the exposure.

> *Principal Protected Notes (PPN) – are a type of investment where payment of contractually promised fixed cash flows (principal and interest thereon) is satisfied by an underlying bond(s), but additional potential returns are generated by non-fixed-income assets in the structure which, if held directly, would be reported on Schedule D – Part 2 – Section 2 – common stock, Schedule A – real estate, Schedule DB – derivatives, or Schedule BA – private equity funds, hedge funds, other equity funds in the form of LP/LLC structures or characteristics of common stock. Investments in PPNs must be submitted to the SVO for analysis.*

Summary

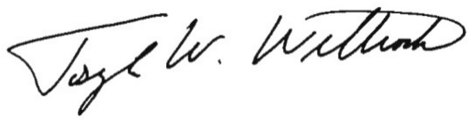
In summary, we suggest the following steps be considered as theEexposure proposal moves forward:

1. consider the revised language we have provided above which we believe creates a clear and specific definition of what constitutes a PPN so any amendment can be consistently implemented;
2. consider how existing accounting treatment's impact to capital (*i.e.*, impairments) would align with proposed changes to required capital;
3. provide more transparency into the process which would be utilized to assign NAIC ratings for PPN investments;
4. request feedback from the industry on potential materiality of exposure given the definition and rating process for PPNs; and

5. use the feedback from #4 above to gauge the impact on the industry and the associated timing of implementation.

We hope you find our comments to be constructive and helpful as the Task Force considers solutions to address PPNs.

Sincerely,



Joseph W. Wittrock, CFA
Senior Vice President and Chief Investment Officer

DELAWARE LIFE®

Mr. Kevin Fry, Chair

NAIC Valuation of Securities (E) Task Force

1100 Walnut Street, Suite 150

Kansas City, MO 64106

Dear Mr. Fry,

We appreciate the opportunity to comment on the proposed amendment to the Purposes & Procedures Manual of the Investment Analysis Office (P&P Manual) to update the definition and instructions for Principal Protected Notes (PPN) and Combo Notes, and removing these classes of securities from eligibility for Filing Exemption (FE).

We strongly support the stated objective of the NAIC Securities Valuation Office to improve asset risk transparency, capital treatment, and proper scheduling for Principal Protected Notes (as defined), Combo Notes, and other structured securities. However, we are concerned that the broad based application of the proposed amendment, as currently contemplated, will result in significant unintended consequences, particularly with respect to structured notes or securitized assets generally. The issues posed should be given proper consideration and analysis. The NAIC should allow for industry comment and involvement in crafting a new rule, which should be appropriately scoped and implemented.

PPN Comment:

The recent proposal from the SVO recommending elimination of the the filing exemption for Principal Protected Notes and to adjust capital requirements due to the perceived riskiness of these securities conflates various forms of structured credit that exist in the market into one overly broad category. The description used by the NAIC is broad and has been interpreted differently by industry participants. As a result, the definition does not draw a clear distinction between the intended target and other structured financings eligible for schedule D reporting such as LBASS securities under SSAP 43R. The industry needs more clarity on how these particular notes are defined as opposed to other structured finance vehicles.

The SVO bases its position on several elements: (i) the notes at issue may include assets that would not otherwise be permitted on Schedule D; (ii) the assets being transferred into the structure are not transparent and may be affiliated with the insurer, and (iii) the SVO's capacity to designate these assets.

Schedule D: The concern with respect to proper scheduling is inconsistent with current practice across asset classes. Reporting structured notes with underlying assets that are technically ineligible for schedule D, occurs regularly. For example, CMBS, RMBS, ABS, are all examples of common general account investments that appear on Schedule D but contain underlying assets that would otherwise appear on other schedules. An NRSRO rated note or bond with bond-like cash flows and bond characterstics is properly scheduled on Schedule D. *We recommend that the proposed amendment be limited to require SVO filings only in those cases where the underlying assets are not schedule D eligible assets or are assets without* *bond or bond-like cash flows. This is consistent with the SVO's presentation on bespoke securities dated 8/4/2019.*

Transparency/Affiliation: We are in favor of improved transparency and disclosure requirements around any affiliated transactions. Concern regarding affiliated investments is also being addressed by SAPWG 2019-03 changes to SSAP 25 regarding affiliated investments, which requires disclosure and additional look-through analysis to identify related parties. Requiring a filing based on a look-through analysis is inconsistent with existing practice as Statutory Accounting Principles do not allow for the consolidation of assets. *Potential issues of transparency, specifically with respect to statutory affiliation, are addressed by SSAP 25.*

SVO Capacity to Designate: Recently, the SVO has taken on additional responsibilities as it relates to privately rated assets with the adoption of rules that require filing rating letters. Prior to taking on even more responsibilities, the SVO should establish clear methodologies that address the concerns of the SVO as well as demonstrates the SVO's ability to designate these assets prior to eliminating the reliance of Nationally Recognized Statistiscal Rating Organizations (NRSRO). Based on the letter from the SVO to the VOSTF, it is not clear if the SVO is aware of the number, size and complexity of the PPN assets currently held by insurers.

Combo Note Comment:

Combo Notes are mentioned but not defined or analyzed in the 8/4/19 memo to the VOSTF, and are also referenced in a recent LCD article as a targeted investment.

Combo notes are distinctly different from the type of asset the NAIC is describing when discussing PPNs. Contrasting features include the following: i) the underlying assets are all schedule D assets; ii) the manager or 3rd party equity shares the first loss risk; iii) the subordinated note is not disregarded for the rating, but rather sensitized and modeled out by an NRSRO; and iv) the notes include many different investors and are marketed broadly.

Combo Notes also do not meet the definition of "bespoke security", which was also raised as an area of concern. The NAIC broadly defines a "bespoke security" as one that is: i) not broadly syndicated (i.e. owned by many parties); ii) created by or for one or a few related insurance companies as an investment and; iii) assigned a credit rating by only one NAIC CRP, often via a private rating. Combo Notes do not meet this criteria.

Combo notes play an important role in the issuance of CLO liabilities. Accounting changes will impact the broader bank loan and CLO market, including the estimated >$120bn of CLO assets held by insurers. Historical loss rates on CLO assets are extremely low, provide diversity to insurer's portfolios, and can be an important asset class for insurers and their policyholders. The white paper issued by the NAIC Capital Markets Bureau on 8/5/19 on leveraged loans provides additional statistical support for the exceptional stability of this asset class. Given the previous filing exempt status and existing guidance under SSAP 43R, a change to require filing of all Combo Notes should be considered a substantive change. *Combo Notes meet the definition of a loan backed security as defined under SSAP 43R, and do not meet the definition of a Principal Protected Note as defined in the proposed modification to the P&P manual and should therefore be scoped out.*

Conclusion:

Given the issues posed above, the many open questions, and the potential unintended consequences of the proposed changes, this matter should not be fast-tracked through committee without first affording the industry meaningful opportunity to comment and provide analysis to better define scope and to define and distinguish the risks the NAIC is looking to address. Additionally, insight into the factors and models that the SVO will use to derive a rating designation for previously FE securities would be helpful.

Thank you so much for your consideration,

Michael K Moran

Michael K. Moran

SVP & Chief Accounting Officer

GUGGENHEIM

GUGGENHEIM LIFE AND ANNUITY COMPANY
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INDIANAPOLIS, IN 46280

September 20, 2019

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Dear Mr. Fry,

We appreciate the opportunity to provide feedback on the Valuation of Securities Task Force exposure regarding 'Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office to update the Definition and Instructions for Principal Protected Notes' ("PPNs").

As disclosed in Part One, Section 4, paragraph c) (ii) (C) of the Purposes and Procedures Manual of the NAIC Investment Analysis Office ("P&P Manual"), the NAIC has authority to determine whether it is appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of a particular asset class. While this is the case, we respectfully request clarification on the definition of the investments required to be filed under this proposal, visibility into the analysis to be conducted by the SVO, an outline for the expected time required by the SVO to produce designations on individual impacted investments and an outline for timing in which this proposal is to be applied to the preparation of Statutory Statements.

<u>Issue background:</u> The memorandum summarizing the issue and the SVO proposal included two examples of investments considered to be PPNs:

1. Zero coupon Treasury bond with notional equal to face amount of the PPN coupled with a call option on the S&P 500.
2. Fixed coupon corporate bond having fixed coupon that covers stated interest on the PPN with excess interest plus the principal on the corporate bond covering the face amount of the PPN. Plus additional undisclosed and unrated assets that may provide additional return.

Regarding these examples, the SVO concluded with three statements that serve as organizing principles for our response letter:

- <u>Asset transformations</u>: Assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that Schedule through financial structuring.
- <u>Affiliate/related party transactions</u>: The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche.
- <u>SVO stated analytical concern</u>: Significant risks are being obscured by focusing only (on) risk associated with the repayment of principal.

<u>Asset transformations:</u> Addressing the statement made in the proposal that both examples include assets that would otherwise be ineligible for reporting on Schedule D, the SVO recommended referring this topic to SAPWG to consider the treatment of the asset transformations described. While it should be generally understood that, most often, securitizations result in transforming many types of

underlying investments—including those not reported on Schedule D—into fixed income securities, we are supportive of such a referral should that create clarity for the industry. In fact, a topic with a similar theme (Collateralized Fund Obligations) is currently being addressed by the SAPWG and we suggest that topic is substantive and should be expanded to include the recommended referral from the SVO.

Affiliate/related party transactions: The SVO indicated that the source of the assets being transferred into principal protected notes and their relationship to the insurer is not transparent. As part of the recommendation, the SVO would alert regulators to the extent that the SVO identified possible affiliated assets. SSAP 25 and SSAP 103R both have measurement and disclosure requirements. We are supportive of improved quality of disclosures providing transparency into affiliated and related party transactions and ongoing exposures to the same. We expect this could be accomplished through other regulatory clarifications that do not require the SVO to assign designations.

SVO stated analytical concern: We appreciate the analytical concern that there may be risks being obscured in these structures. However, we do not fully understand how this concern is addressed by the SVO recommendation. Mostly, this stems from a lack of clear definition of the assets to which the proposal would be applied. We are concerned that the definition laid out in the SVO proposal differs from industry standard definitions found on Bloomberg or other reputable sources. The result may be inconsistent application across the industry.

Implementation and timing: We are concerned about the pace in which it appears this topic is to be implemented. In addition to the potential impact to RBC, a shift in the rules may impact surplus due to an adverse change to market pricing on impacted investments should companies desire to transact in order to exit positions. In the past, substantive changes to the regulatory framework have been studied to understand their impact prior to adoption of any recommended change. We request similar application in this matter, being mindful of unintended scope expansion to additional investments. In order to complete such a study effectively, we assert that the SVO must clearly articulate the nature of the analysis and the expected outcome on the affected investments.

We understand the SVO has no interest in grandfathering current investments. We agree that such grandfathering would be inappropriate. Instead, we suggest that the SVO provide transparency on how they would assign designations to affected investments and allow a reasonable transition period for affected companies to manage the potential impacts to investments that were acquired in accordance with and under a previous set of regulatory standards.

What seems imperative to a healthy regulatory environment and the financial stability of individual companies is a more deliberative and transparent approach to this issue. We look forward to continuing work with the SVO and the Task Force to achieve regulatory objectives in support of a healthy insurance industry.

Best regards,

Ellyn M. Nettleton

Ellyn M. Nettleton
Controller and Treasurer

Bradley Anderson

Bradley Anderson
Investment Valuation and Analysis

KBRA KROLL BOND RATING AGENCY

September 19, 2019

VIA EMAIL
Mr. Kevin Fry
Chairman, Valuation of Securities (E) Task Force,
National Association of Insurance Commissioners
and
Chief Operating Officer
Illinois Department of Insurance
320 West Washington Street, Fourth Floor
Springfield, IL 62767

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "P&P Manual") to update the Definition and Instructions for Principal Protected Notes ("PPNs")

Dear Chairman Fry and Members of the Valuation of Securities (E) Task Force:

Kroll Bond Rating Agency, Inc. ("KBRA") thanks you for the opportunity to submit this letter during the open comment period concerning the proposal to amend the P&P Manual's definition of PPNs and the instructions for reporting PPNs (the "Proposal"). KBRA generally supports the Task Force's objective of properly understanding and evaluating the risk of securities that are held by regulated insurance companies. KBRA also has reviewed the Securities Valuation Office's July 2, 2019 memorandum regarding the Proposal (the "Memo"). Given that KBRA and the Task Force share the goal of accurately assessing risk, KBRA's purpose in submitting this letter is to clarify KBRA's understanding as to certain matters of fact set forth in the Memo.

KBRA believes that a security is not necessarily more or less risky solely because the security features a PPN in its structure. The main question should be: are the cash flows generated by the collateral supporting a debt instrument capable of meeting the principal and interest payment obligations of the transaction? For example, there may be transactions structured with PPNs where the collateral consists solely of AAA rated U.S. Treasury Bonds. Instead of evaluating the actual risk associated with the collateral, the Proposal would treat such a transaction the same way it would treat one that incorporates a PPN secured solely by non-investment grade securities. Conversely, a debt transaction that is secured by those same non-investment grade securities, but which does not include a PPN in its structure, would not be excluded by the PPN prohibition articulated in the Proposal. Whether a structure includes a PPN is important, but it should be a secondary consideration that should be incorporated into an

KBRA KROLL BOND RATING AGENCY

analysis of the structural risks of any transaction. In short, KBRA does not believe that PPNs are inherently risky.

KBRA believes that analyzing risk must include, but should not be limited to, a transaction's structural features. More importantly, KBRA believes that all risks, including collateral and structural features, should be analyzed together in order to properly assess risk. KBRA welcomes the opportunity to participate in more conversations around these issues.

Sincerely,

Jim Nadler
Chief Executive Officer and President
Kroll Bond Rating Agency, Inc.

Patrick Welch
Chief Credit Officer
Kroll Bond Rating Agency, Inc.

cc: Mr. Charles Therriault
Director, Securities Valuation Office
National Association of Insurance Commissioners (via email)

Ms. Denise Genao-Rosado
Senior Administrative Assistant
National Association of Insurance Commissioners (via email)

Mike Monahan
Senior Director, Accounting

Tracey Lindsey
President

September 20, 2019

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Mr. Stewart Guerin, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64016-2197

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to update the Definition and Instructions for Principal Protected Notes

Dear Messrs. Fry and Guerin:

ACLI[1] and NASVA[2] ("the undersigned") appreciate the opportunity to provide feedback on the Valuation of Securities Task Force ("the Task Force") exposure regarding 'Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to update the Definition and Instructions for Principal Protected Notes' ("the exposure"). Although we agree with the Analytical Concern stated in the exposure, as it relates to the example securities provided, we have three potential concerns: Securities Valuation Office ("SVO") Capacity to Designate, Unintended Scope Expansion and Prospective Application. We will address each of these concerns below in greater detail.

SVO Capacity to Designate

We note the SVO has taken on various additional designation responsibilities and we have some concerns on whether the SVO has the capacity to designate further securities. There are also concerns that the SVO may not yet have an established and vetted rating methodology developed for the unique Analytical Concern presented by Principal Protected Notes ("PPNs"). Furthermore, given the nuances of existing standards regarding SVO authority to evaluate different types of structured securities, not to mention

[1] The ***American Council of Life Insurers*** (ACLI) advocates on behalf of 280 member companies dedicated to providing products and services that promote consumers' financial and retirement security. 90 million American families depend on our members for life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, dental and vision and other supplemental benefits. ACLI represents member companies in state, federal and international forums for public policy that supports the industry marketplace and the families that rely on life insurers' products for peace of mind. ACLI members represent 95 percent of industry assets in the United States. Learn more at www.acli.com.

[2] The ***North American Securities Valuation Association*** (NASVA) is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes.

additional possible components of PPNs (commodities, derivatives, equities, etc.), the absence of greater elaboration on the proposed methodology for PPNs concerns some of our membership. Our ask is that these issues are thoroughly vetted prior to adopting any further guidance related to PPNs.

It would be helpful if the major tenets of the rating methodology that will be used (or developed) to designate such securities could be shared with industry, including the extent to which approved credit rating provider (CRP) ratings will be considered. Structured finance assets provide insurance companies access to solid risk adjusted returns at a time when higher yields are scarce, and to cash flows streams that are often well suited to our asset/liability matching ("ALM") needs. Given the potential implications for insurance companies weighing risk adjusted return opportunities that will support the ability to meet future policy holder obligations, we believe additional insight into the designation process will help provide clarity for insurers and minimize market uncertainty.

<u>Unintended Scope Expansion</u>

The exposure states:

> These additional assets are intended to generate an excess return, we call them the "performance assets;" such as, derivatives, common stock, commodities, equity indices, etc. … essentially any asset. The performance assets may include undisclosed assets and are typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond.
>
> The SVO has reviewed a dozen or more of these securities. They share a consistent theme; the external credit rating provider (CRP) rating is based solely on the component dedicated to the repayment of principal and ignores the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1.
>
> In both examples, assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that schedule through financial structuring. Significant risks are being obscured by focusing only risk associated with the repayment of principal.

The exposure appears focused on the primary concern that external CRP ratings do not always fully depict the risks inherent to PPN investments. In such instances, the concern may arise that use of such CRP ratings under the Filing Exempt process would allow the investments to appear on Schedule D, Part 1 as structured securities, providing the impression to financial statement users that the investment risks are confined to the credit risk implied by the CRP rating. Absent contractual overlays that transform the risks to invested basis into solely those relating to the capacity of the obligor to make contractually promised payments, a portion of the carry value presented as a fixed-income like investment with a particular credit profile in the statutory financial statements could be exposed to the types of risks that would garner different classification and measurement/valuation under the applicable statutory guidance (e.g., risks associated with non-Schedule D, Part 1 eligible asset classes such as derivatives, equities, commodities, etc.). Viewed through this lens, we do not take issue with the elaborative language identifying concern that, in such instances, the CRP rating's focus on only one of several inherent risks could fail to meet the regulatory objective.

However, the literal language drafted as the proposed amendment appears to expand beyond the objective of gaining additional visibility into the risks inherent to PPN investments. Mindful of unintended scope expansion, we feel the definition of PPNs within the proposed amendments should be updated to focus on characteristics indicating heightened risk that the security's CRP rating is based solely on the underlying asset component dedicated to the repayment of principal and interest, and ignores the risk associated with the underlying performance assets. This appears to be a primary concern targeted by the exposure. We would like to offer a revised definition to dispel potential ambiguities as to the scope of the proposed amendments and facilitate consistent application across reporting entities:

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

MEMORANDUM

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

FROM: Charles Therriault, Director, NAIC Securities Valuation Office
Eric Kolchinsky, Director, NAIC Structured Securities Group

CC: Jeff Johnston, Managing Director, NAIC Financial Regulatory Affairs
Marc Perlman, Investment Counsel, NAIC Securities Valuation Office

DATE: February 27, 2020

RE: Issue Paper – IAO staff concerns about Bespoke Securities, and Reliance on CRP Ratings

1. **Introduction** – During the Task Force's May educational session, the IAO staff discussed with the Task Force its growing concern with bespoke securities - financial instruments typically constructed by or for a small group of investors, which, due to their private nature, are not subject to or constrained by market forces and competition. As such, their visible characteristics may substantially underrepresent actual risks. We highlighted specific securities to the Task Force as part of our growing concern about what we believe is the NAIC's excessive reliance on credit rating provider (CRP) ratings to assess investment risk for regulatory purposes. During the session, the Task Force members that participated agreed with these concerns, noting that it would be beneficial for the IAO staff to develop guidance for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) that would allow the IAO staff to flag certain bespoke transactions and in turn create a process that would either dissuade industry's use of such transactions or limit the risk. While some regulators suggested technology solutions be developed that allow regulators to follow-up with insurers on flagged transactions, most of the regulators questioned their own ability to do so given existing time constraints and the likely expertise needed to analyze the securities and communicate with insurers on each such issue. During that session, the regulators suggested IAO staff develop a summary of the issues and make recommendations to remediate them. This memorandum serves that purpose and builds upon specific direction given to the IAO by the Task Force at the Summer National Meeting held on August 4, 2019, to prepare an issue paper outlining the risks posed by bespoke securities after the IAO's presentation on this issue at that meeting and make recommendations to mitigate these risks along with the interrelated issue of relying upon CRP ratings.

2. **Analytical Concern** –

   a. Bespoke securities **-** The term "bespoke" made its way to finance from the world of London tailors producing "made to measure" suits for their banking clients. For the following reasons these customized financial instruments are typically not constrained by market forces and competition and, as a result, may substantially underrepresent risk:

      i. These securities are usually not broadly syndicated (i.e. not owned by many parties).

      ii. They are created by or for one or a few related insurance companies as an investment.

iii. They are assigned a credit rating by only one NAIC CRP, often via a private rating.

iv. Participants often deliberately keep the terms and structure private.

As we mentioned in our presentation, bespoke securities, by definition, exhibit a great deal of flexibility in form making them, as a category, very difficult to describe, beforehand (i.e. they can include all possible variations). Since these are "one-off" and often private securities, no third-party lists or data exist that are sufficient to identify them in any insurer portfolios. Even if they were clearly identifiable, the SVO currently staff lacks the authority to act upon any issues or concerns it may have when, in its opinion, a security or a CRP rating incorrectly reflects how NAIC guidance would treat or view that security.

b. Reliance on CRP ratings – The Task Force's use of CRP ratings to determine an NAIC designation pursuant to the filing exempt (FE) policy, and the related historically permitted practice of allowing private ratings for this same purpose, has evolved into the current situation where the NAIC has very little oversight over the use and analytical basis of the CRP ratings being used to assess risk for the vast majority of insurer investments. The NAIC relies on nine different CRPs today with a tenth CRP in the process of being added and other entities considering becoming an U.S. Securities and Exchange Commission (SEC) nationally recognized statistical ratings organization (NRSRO), a necessary step before becoming a CRP to the NAIC. As direct competitors, each rating entity employs different methodologies and processes that make their ratings product unique. The SEC monitors compliance with those processes and adherence to those methodologies but they do not opine on the quality or veracity of the methodologies or their applicability for NAIC purposes.

The Task Force has not required the SVO to monitor CRP ratings or their methodologies for consistency and applicability and the SVO has not been authorized to use its judgement to determine how and when, if at all, a CRP rating should be used for NAIC purposes. We believe this lack of staff oversight has enabled the increased use of bespoke securities and, more importantly, has permitted a very significant population of securities to be assigned NAIC designations through the FE process (~82% of all securities owned by insurers) based on methodologies that are currently unmonitored by the NAIC as to how risk is being assessed for regulatory purposes and how the security complies with NAIC policies. While we believe that the CRPs follow their published methodologies, as required by the SEC, we <u>do not believe that every rating agency methodology is appropriate for, or consistent with, the assessment of investment risk for statutory purposes</u>. The Credit Rating Agency Reform Act of 2006 (CRARA) requires NRSROs to make certain information public to help users of credit ratings compare NRSROs and assess their credibility. The philosophy behind the CRARA regulation of NRSROs is disclosure and "buyer beware". In keeping with the intent of CRARA, we believe the NAIC, as a consumer of CRP ratings, needs to actively apply its own judgement in how it uses CRP ratings. This is also consistent with the recommendations made by the Rating Agency (E) Working Group that were subsequently adopted by the Financial Condition (E) Committee in the Working Group's final report dated April 28, 2010 (excerpts of which are included in this paper and the full report accompanies it). The CRPs have thousands of methodologies between them; managing and administering their appropriate use for NAIC purposes would require the SVO to be given additional authority and discretion from the Task Force.

Concerns about inflated CRP ratings are not unique to the NAIC. For example, a letter from a bipartisan group of Senators to the SEC cited a Wall Street Journal article discussing a rating agency practice of changing methodology to gain business. The letter noted that the CRPs "have changed their rating criteria in ways that were followed by big jumps in market shares…"

3. **Recommendations** –

a. Bespoke securities "Red Flags" – For any security that trips one or more of the following "red flag" criteria, the SVO would require its legal agreements submitted to the SVO so the SVO could assess whether the security and/or the CRP rating were appropriate for NAIC purposes. If the SVO deemed the security acceptable but not the CRP rating, the security would need to be filed with the SVO for a complete analysis. If the SVO deemed the security unacceptable, the SVO would work with the appropriate regulatory groups to address any policy matters.

i. Rating from a single CRP. At least two independent CRP ratings would be required for any NAIC designation to be derived from CRP ratings and the lower of the ratings would be applied. In the absence of two CRP ratings, the security would need to be filed for analysis by the SVO.
ii. Private letter rating. The analysis supporting the assignment of any private rating would need to be submitted to the SVO for review. The SVO would have the authority to determine if it would rely upon the private rating or require the security to be filed. The analysis would need to be provided at least annually.
iii. Assets backing the security were primarily owned by insurer or affiliates before the transaction and reported differently (i.e. regulatory arbitrage)
iv. Assets backing the security do not generate bond-like cash flows (i.e. contractual requirements to pay periodic principal and interest).
v. Insurer or affiliated group are sole investors in security
vi. Affiliate of company is underwriter or sponsor of the security

b. Reliance on CRP ratings – The SVO would be tasked with monitoring CRP ratings and methodologies on a case-by-case basis and determining how they are used in the filing exemption process. The production of NAIC designations using CRP ratings is already an SVO administrative responsibility. Authorizing the SVO to oversee the applicability of those CRP ratings would add much needed oversight to the NAIC's use of CRP ratings. . One of stated objectives of the NAIC's use CRP ratings should be to achieve the greatest consistency and uniformity in the production of NAIC designations while maximizing the alignment between the assessment of investment risk to the NAIC's statutory objectives.

4. **Recommendations of the Rating Agency (E) Working Group ("RAWG") -** The risks and concerns being highlighted in this paper echo those identified in the final report of the Rating Agency (E) Working Group ("RAWG") dated April 28, 2010, and the recommendations above are consistent with the Working Group's that were also adopted by the Financial Condition (E) Committee; some of which are listed below in italics (the full report is attached):

a. Summary of Recommendations

The Working Group recommends that:

i. Regulators explores how reliance on ARO ratings can be reduced when evaluating new, structured or alternative asset classes, particularly by introducing additional or alternative ways to measure risk;

ii. Consider alternatives for regulators' assessment of insurers' investment risk, including expanding the role of the NAIC Securities Valuation Office ("SVO"); and

iii. When considering continuing the use of ratings in insurance regulation, the steps taken by the NRSROs in correcting the causes that led to recent rating shortfalls, including the NRSROs' efforts in implementing the recommended structural reforms, should be take into account.

… (VOS recommendations) …

b. VOS should study the use of ratings in the financial solvency monitoring of insurance companies to confirm it ratings should differ for municipal, corporate and structured securities as general asset classes. Consideration should also be given to applying ratings differently within segments of these broader categories.

c. *An evaluation should be made to determine whether the differences between ratings for municipal and other securities is material enough to warrant change how ARO ratings are converted into NAIC designations.*

d. *VOS should continue to develop independent analytical processes to assess investment risks. These mechanisms can be tailored to address unique regulatory concerns and should be developed for use either as supplements or alternatives to ratings, depending upon the specific regulatory process under consideration.*

e. *ARO ratings have a role in regulation; however, since the ratings cannot be used to measure all the risk that a single investment or a mix of investments may represent in an insurer's portfolio, NAIC policy on the use of ARO ratings should be highly selective and incorporate both supplemental and alternative risk assessment benchmarks.*

f. *NAIC should evaluate whether to expand the use of SVO and increase regulator reliance on the SVO for evaluating credit and other risks of securities.*

g. *The NAIC Rating Agency (E) Working Group should establish a process to monitor and evaluate ARO activities. A monitoring function would:*

   i. *Provide information about product offerings and the direction of financial innovation.*

   ii. *Permit timely regulatory intervention to set regulatory treatment of risk securities differently than that suggested by their credit quality.*

   iii. *Promote, if not require, rating agency transparency of process, compensation, staff participation, and collateral underlying the security.*

   iv. *Determine the materiality of risks other than credit to financial solvency.*

   v. *Monitor and assess the changes that ratings agencies are implementing, and whether ratings continue to correctly complement regulatory purposes.*

h. *The SVO does not take part in the structuring of securities transactions for issuers and is not subject to the competitive pressure that can lead to the conflicts of interest discussed throughout this report; therefore, state regulators should evaluate whether to expand the SVO's role.*

i. *Modify the Filing Exempt Rule:*

   i. *VOS should consider developing alternative methodologies for assessing structured security risks. Those structured security classes where an alternative method is adopted would be ineligible for filing exemption.*

   ii. *VOS should consider if new investment productions should be ineligible for filing exemptions and/or instead by subject to regulatory evaluation. Filing exempt status can be granted or withheld on the basis of the regulatory review.*

   iii. *VOS should study the use of ratings in the financial solvency monitoring of insurance companies to confirm if ratings should differ for municipal, corporate and structured securities as general asset classes. Consideration should also be given to applying ratings differently within segments of these broader categories.*

iv. *Consideration should be given to modifying the filing exempt rule to adjust for securities with new additional ARO ratings and other measures (such as V Scores and Parameter Sensitivities) when deemed applicable. The need for difference RBC and/or some other and additional regulatory process should be evaluated. Such processes could include the use of market information on price direction and of yield trends in addition to ARO ratings for some or all filing exempt securities.*

Securities highlighted by this process can be reviewed by the SVO with the objective of adjusting the ARO rating to help ensure an accurate RBC charge.

v. *VOS should develop tools to better address market and liquidity risk in structured securities*

5. **Next steps –** The IAO recommends sharing the issue paper with Financial Condition (E) Committee to alert them to these continuing risks highlighted in the Rating Agency (E) Working Group's recommendations and continuing this discussion next year.

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Attachment E-1
Valuation of Securities (E) Task Force
4/9/2020

Draft: 5/5/10

Financial Condition (E) Committee
Conference Call
April 28, 2010

The Financial Condition (E) Committee met via conference call April 28, 2010. The following Committee members participated: Alfred W. Gross, Chair (VA); Joseph Torti, III, Vice Chair (RI); Linda S. Hall represented by Gloria Glover (AK); Steve Poizner represented by Al Bottalico (CA); Susan E. Voss represented by Kim Cross (IA); Ann M. Frohman represented by Jim Nixon (NE); Thomas B. Considine represented by Steve Kerner (NJ); James J. Wrynn represented by Matti Peltonen, Lou Felice and Joseph Fritsch (NY); Mary Jo Hudson represented by Dale Bruggeman (OH); and Sean Dilweg represented by Peter Medley.

1. Rating Agency (E) Working Group Report

Commissioner Gross stated that the report from the Rating Agency (E) Working Group was received by the Committee at the Spring National Meeting. He said there were no objections to the report during that meeting, but he wanted to give each of the chairs of the impacted groups time to review the report before adopting it. He stated that some comments had been received by the chairs since being distributed, and those had been incorporated into the report. He characterized the changes as editorial, noting that they mostly clarified that each of the recommendations would be more fully considered by each of the applicable technical groups. He asked if there were any concerns from the Committee members or the chairs. Mr. Fritsch indicated he had no concerns with the recommendation being sent to the group he chairs. No other regulators expressed any issues. A motion was made by Superintendent Torti to adopt the revised report (Attachment Fifteen-A) from the Rating Agency (E) Working Group. The motion was seconded by Mr. Bottalico and unanimously carried.

2. Rating Agency (E) Working Implementation Matrix

Commissioner Gross asked NAIC staff to provide a summary of the implementation matrix that had been created to track the progress of the recommendations from the Rating Agency (E) Working Group. Dan Daveline (NAIC) described a matrix that he had drafted at the direction of Commissioner Gross. He discussed the columns of the report, and how each group was expected to complete after discussing on a conference call and then distribute it to the Rating Agency Working Group. He discussed how each group was intended to identify if any of the recommendations could not fit into the group's existing charges and if any of the items were more long-term issues that could not be addressed quickly because of competing priorities or the need to coordinate with other projects. An example was provided of a referral to the Capital Adequacy (E) Task Force that involves a decision that will likely need to be made by the Solvency Modernization Initiative (EX) Task Force. The intent is for the report to be updated before each national meeting and provided to the Committee at such time.

Commissioner Gross discussed a charge that was developed as a means to successful implementation of the recommendations from the Rating Agency (E) Working Group. Commissioner Gross read the charge:

> *Monitor the implementation of recommendations resulting from the NAIC's evaluation of the reliance on nationally recognized statistical rating organization (NRSRO) ratings. Provide a status of the recommendations to the Financial Condition (E) Committee at each NAIC national meeting until the majority of the recommendations have been implemented or disposed.*

A motion was made by Superintendent Torti to adopt the charge to the Rating Agency (E) Working Group. The motion was seconded by Mr. Fritsch and unanimously carried.

Having no further business, the Financial Condition (E) Committee adjourned.

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Attachment E-1
Valuation of Securities (E) Task Force
4/9/2020

To: The Honorable Alfred Gross, Virginia Commissioner of Insurance and Chair of the Financial Conditions (E) Committee
From: The Honorable Michael McRaith, Director of the Illinois Department of Insurance and Co-Chair of the Rating Agency (E) Working Group
The Honorable James J. Wrynn, Superintendent of the New York Insurance Department and Co-Chair of the Rating Agency (E) Working Group
Matti Peltonen, New York Insurance Department
Kevin Fry, Illinois Insurance Department
Bob Carcano, Senior Counsel, SVO
Re: Evaluating the Risks Associated with NAIC Reliance on NRSRO Credit Ratings – Final Report of the RAWG to the Financial Conditions (E) Committee
Date: April 28, 2010

I. Introduction - The Rating Agency (E) Working Group ("RAWG") of the NAIC Financial Condition (E) Committee was formed on February 11, 2009, and charged with conducting a comprehensive evaluation of state insurance regulatory use of the credit ratings of nationally recognized statistical rating organizations ("NRSROs").[1] Specifically, the Working Group was charged to gather and assess information on:

1. The problems inherent in reliance on ratings, including impact on the filing exempt ("FE") process and Risk-Based Capital ("RBC");

2. The reasons for recent rating shortcomings, including but not limited to structured security and municipal ratings;

3. The current and potential future impact of ratings on state insurance financial solvency regulation; and

4. The effect of the use of NRSRO ratings on public confidence and public perception of regulatory oversight of the quality of insurance.

This report presents the Working Group's findings in answer to those charges and recommendations to adjust the use of ratings.

II. Summary of Recommendations

The Working Group recommends that:

1. Regulators explore how reliance on ARO ratings can be reduced when evaluating new, structured, or alternative asset classes, particularly by introducing additional or alternative ways to measure risk;

2. Consider alternatives for regulators' assessment of insurers' investment risk, including expanding the role of the NAIC Securities Valuation Office ("SVO"); and

3. When considering continuing the use of ratings in insurance regulation, the steps taken by the NRSROs in correcting the causes that led to recent rating shortfalls, including the NRSROs' efforts in implementing the recommended structural reforms, should be taken into account.

[1] The NRSROs whose ratings are used by the NAIC are referred to as Acceptable Rating Organizations ("ARO"). Currently, they are Standard & Poor's, Moody's, Fitch, DBRS, A.M. Best, and Realpoint.

III. Overview of the RAWG Process

Soon after the RAWG was formed, SVO staff was directed to:

1. summarize federal and international regulators' evaluations of NRSRO rating shortcomings;
2. assess the role of these shortcomings in the current economic crisis;
3. identify the specific NAIC regulatory mechanisms driven by ratings;
4. quantify the impact of rating downgrades on insurance companies.

The RAWG sent a questionnaire based on state regulators' points of interest in the NRSRO structure and process to the AROs. An SVO team of analysts (all of whom are alumni of the AROs with extensive rating agency experience) evaluated the responses and summarized them for the RAWG.

On September 24, 2009, at the NAIC Fall National Meeting, the RAWG held a public hearing and received testimony from capital market participants, ARO representatives and national experts on the use of ratings in regulation. The September 24 hearing provided information and perspective which is included in, or formed the basis for, many of the recommendations contained in this Report.

A second public hearing, via conference call, was held on November 18th to gather information about ARO rating of municipal securities.

IV. Findings of the Working Group

1. Problems Inherent In Reliance on Ratings for Insurance Regulation

AROs are for-profit business organizations which seek to expand the reliance upon ARO ratings in financial products and regulatory processes in order to develop new product lines and increase market share. The largest AROs also compete to obtain business from the issuers of the securities subject to the ARO rating. Reliance on ratings exposes insurance regulatory process to risks arising from competitive pressures on AROs that are beyond state regulators' control and not consistent with regulatory objectives, such as consumer protection.

a. Ratings are used extensively in insurance regulation. In addition, insurers should be required to use such tools as due diligence reviews of investments, risk management, independent credit analysis, and risk diversification.

b. Insurance regulators' extensive reliance on ratings, often required by statute, may reduce regulators' independent ability to monitor an insurance company's compliance with prudent investment practices.

c. Rating agencies' use of corporate bond default history as the basis for analyzing structured securities was based on an underlying assumption that the default rates for the two classes would behave similarly in varying market scenarios. The fundamental differences in the structures of the securities and the cash flows render these types of securities so fundamentally different from one another that the use of corporate bond default history to form an opinion on the probability of particular structured securities' performance was inappropriate.

d. Rating agencies' rating revisions tend to lag behind market and economic developments. ARO ratings tend to be long-term ratings, meant to be relatively stable over an economic cycle. As a result, ratings may not react fast enough or be sufficiently current to satisfy regulatory needs.

e. Complex securities, such as Collateralized Debt Obligations consist (in effect) of options on derivatives and contain a great deal of leverage. As a result, the effects of AROs adopting assumptions that would later prove far different from actual experience were magnified greatly. If the assumptions do not correctly anticipate these securities' actual behavior in a given environment, then the probability that the rating will not reflect the true creditworthiness of that security will increase exponentially.

f. To verify the accuracy of ratings and the validity of initial assumptions and models for structured securities, it is necessary to monitor the performance of the underlying assets. Rating agencies, however, rarely engage in monitoring sufficient to discover such problems, after having issued the initial rating.

g. Due to competition and the increasingly complex nature of financial products, the meaning of ratings and the comparability of structured product ratings between NRSROs have changed. These changes require investors to increase their expertise about credit and the NRSOs' rating methodology before ratings can be expected to be adequately understood.

h. Credit ratings focus on the probability of default, and thus do not capture all investment risks. Credit ratings do not measure recovery given default, and therefore cannot be used to estimate the actual expected losses in insurers' investment portfolios. Rating agencies have, or are in the process of adding separate recovery ratings at least to some fixed income securities, but it remains to be determined how comparable they are.

i. In order for the NAIC's filing exempt rule to work well, the ARO ratings need to be consistent. Currently, however, the ARO ratings are neither consistent nor uniform for individual securities, nor across different types and classes of securities.

j. AROs use the same rating scale for municipal and corporate securities indicating that the probability of default for municipal and corporate securities are similar, when in fact, the probability that a municipal security defaults is lower than that of a corporate security with the same rating.

k. The process by which ARO ratings are transposed into NAIC designations to determine the appropriate surplus levels under RBC assumes the default rates and losses given default assumptions for municipal and corporate securities are similar.

l. These differences in default probability (and in the possibility of differing losses given default) across asset categories, and the assumption incorporated into the NAIC designations that these differences do not exist, can result in anomalous situations where the capital held against various investments bears less relation to the actual risk presented than is warranted.

2. Reasons for Recent Rating Shortcomings

The RAWG's hearings identified the following factors as contributing to errors when NRSRO ratings alone are used for regulatory purposes.

a. When rating structured credit or non-standard fixed income products with little or no historical data, AROs have sometimes adopted models incorporating either excessively optimistic assumptions or inadequate probability given to severity of tail risk.

b. It appears that some AROs have responded to business opportunities by choosing not to reject transactions submitted for ratings. These same pressures appear to have contributed not only to"grade inflation" of credit ratings, but also to a conflation and a decline in the quality of rating standards.

c. Rating agencies that are compensated primarily for their initial ratings have little incentive to monitor underlying asset performance on structured securities or modify or update their ratings generally.

3. Current and Potential Future Impact of Ratings on Regulation

The NAIC is engaged in several reform measures that will reduce regulators' reliance on credit ratings. First, the NAIC is supporting regulators as risk-focused examinations are implemented by states, and second, the NAIC has amended its treatment of Residential Mortgage Backed Securities ("RMBS"), and is evaluating the merits of expanding a similar type of credit evaluation to other structured securities. Both of these reforms will allow regulators to "drill down" to reveal levels of granularity within a security that are not accessible through credit ratings.

The RMBS proposal replaced ratings with a model (modeling was done by PIMCO Advisory) to establish price ranges for each NAIC designation (1 through 6) for each of the approximately 21,000 different RMBS held by insurance companies. An insurer's carrying value for a particular RMBS was mapped to the price ranges to identify the appropriate NAIC designation for use in RBC. This approach: (1) identifies the actual risks presented by RMBS; (2) quantifies the severity of possible losses; (3) provides a better measure of losses against which surplus must be kept; and (4) when appropriate, frees up capital, in particular for securities held at a discount.

4. The Effect of the Use of ARO Ratings on Public Confidence and Public Perception of the Quality of Regulatory Oversight of Insurance

Congress and the Securities and Exchange Commission have considered increasing the number of entities designated as NRSROs**.** As the number of AROs increases, so will the competitive pressures. Where issuers pay for AROs for rating services, these competitive pressures may create incentives within the AROs that would be incompatible with prudential supervisory considerations. There is a risk that required checks and balances will be developed only after major ratings failures occur – as has been the clear pattern during the current and prior episodes of inaccuracy of credit ratings.

a. Ratings have devolved to the point where they can be most appropriately interpreted and applied only by financial professionals who understand the rating agencies' methodologies and the implications that specific circumstances have for those methodologies.

V. Recommendations

1. Referral to the NAIC Capital Adequacy Task Force: The current RBC process should be reviewed to assess the recent performance of ratings for structured securities and how that performance has affected insurers' surplus and reserve holdings.

2. Referral to the NAIC Valuation of Securities Task Force: VOS should study the use of ratings in the financial solvency monitoring of insurance companies to confirm if ratings should differ for municipal, corporate and structured securities as general asset classes. Consideration should also be given to applying ratings differently within segments of these broader categories.

3. Referral to the NAIC Valuation of Securities (E) Task Force: An evaluation should be made to determine whether the difference between the ratings for municipal and other securities is material enough to warrant changing how ARO ratings are converted into the NAIC designations.

4. The NAIC Rating Agency (E) Working Group should evaluate whether states', municipalities' and other public entities' creditworthiness should take into account the unprecedented financial burdens many public sector issuers face from aging populations, public pension liabilities, infrastructure needs, and revenue instability caused by financial and economic dislocations.

a. The diminished market share of monoline bond insurers (less than 10% of new issues are guaranteed - down from about 50% before the 2008 financial crisis), renders the valuation and credit risk assessment of many municipal bonds more difficult. As a result, the credit quality of insurers' municipal bond portfolio is more opaque, and may require a more frequent and detailed reporting. Heightened reporting levels will enhance transparency and provide regulators information sufficient to assess creditworthiness of the issuer. Many municipal bonds without the guarantee are not actively traded, which also reduces if not eliminates any pricing discovery, and accuracy, the bonds might have had when insured and more liquid. An alternative valuation method may need to be developed, as the NAIC methodology of matrix pricing using comparable bonds may have limitations due to the difficulty of establishing benchmarks, in particular for small municipal issuers.

b. Given the impact on municipal finances from the possible protracted equity market downturn, from expected losses in the commercial real estate market, and from the continuing foreclosures in residential real estate market, the credit assessment of municipal bond portfolios should assess the risk of unfunded pension and employee/retiree healthcare liabilities, the growth rate of many government programs (e.g. healthcare, childcare, aged home care) which generally exceeds the growth of government revenues. Continuing municipal fiscal burdens and pressures, and unprecedented burdens resulting from the "baby boomer" generation, may necessitate alternative views and assessments of municipal creditworthiness. Recent municipal defaults in South Carolina, Pennsylvania and Nevada illustrate the sensitivity of this time.

c. Regulators should evaluate development of a series of indicators/scales prepared for regulators as warning signs in municipal issues (especially those without strong general obligation support). These indicators could include: i) Liquidity -given the thin secondary market and overall reduced quality of many issues, liquidity is an increasing concern, ii) Sustainability - (as CALPERS and others have raised) on long portfolios given pension, OPEB and social service programs, iii) Municipal Tax Capacity - whether the government has sufficient taxing capacity and authority to satisfy current and prospective obligations, as opposed to neighboring or "competitive" taxing authorities, iv) scrutinize the risk among variant life terms of debt, and v) establishment of thresholds or milestones for reserve adjustments.

5. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should continue to develop independent analytical processes to assess investment risks. These mechanisms can be tailored to address unique regulatory concerns and should be developed for use either as supplements or alternatives to ratings, depending on the specific regulatory process under consideration.

6. Referral to the NAIC Valuation of Securities (E) Task Force: ARO ratings have a role in regulation; however, since ratings cannot be used to measure all the risks that a single investment or a mix of investments may represent in an insurer's portfolio, NAIC policy on the use of ARO ratings should be highly selective and incorporate both supplemental and alternative risk assessment benchmarks.

7. Referral to the NAIC's SVO Initiatives (EX) Working Group: NAIC should evaluate whether to expand the use of SVO and increase regulator reliance on the SVO for evaluating credit and other risks of securities.

8. Referral to the SVO Initiatives (EX) Working Group: Consider whether the NAIC should establish a not-for-profit rating agency where ARO rating coverage is not adequate.

9. The NAIC Rating Agency (E) Working Group should establish a process to monitor and evaluate ARO activities. A monitoring function would:

a. Provide information about product offerings and the direction of financial innovation.

b. Permit timely regulatory intervention to set regulatory treatment for risky securities differently than that suggested by their credit quality.

c. Promote, if not require, rating agency transparency of process, compensation, staff participation, and collateral underlying the security.

d. Determine the materiality of risks other than credit to financial solvency.

e. Monitor and assess the changes that the rating agencies are implementing, and whether ratings continue to correctly complement regulatory purposes

10. Referral to the SVO Initiatives (EX) Working Group: The SVO does not take part in the structuring of securities transactions for issuers and is not subject to the competitive pressures that can lead to the conflicts of interest discussed throughout this report; therefore, state regulators should evaluate whether to expand the SVO's role.

Modify the Filing Exempt Rule

11. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should consider developing alternative methodologies for assessing structured security risks. Those structured security classes where an alternative method is adopted would be ineligible for filing exemption.

12. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should consider if new investment products should be ineligible for filing exemption and/or instead be subject to regulatory evaluation. Filing exempt status can be granted or withheld on the basis of the regulatory review.

13. Referral to the NAIC Valuation of Securities (E) Task Force: Consideration should be given to modifying the filing exempt rule to adjust for securities with new additional ARO ratings and other measures (such as V Scores and Parameter Sensitivities) when deemed applicable. The need for different RBC and/or some other and additional regulatory processes should be evaluated.[2] Such processes could include the use of market information on price direction and of yield trends in addition to ARO ratings for some or all filing exempt securities.

    Securities highlighted by this process can be reviewed by the SVO with the objective of adjusting the ARO rating to help ensure an accurate RBC charge.

14. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should develop tools to better address market and liquidity risk in structured securities.

[2] V Scores address the degree of uncertainty around the assumptions that underlie structured ratings (*i.e.* data limitations and modeling assumptions). Parameter Sensitivities address the sensitivity of Moody's ratings to changes in key assumptions, and so measure how the initial rating might differ if key rating input parameters were varied.

Company Specific Action

15. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should consider requiring insurance companies to provide enhanced documentation for their investment policies and procedures to their regulators, to demonstrate they have a sound basis for their investment strategies.

16. Referral to the NAIC Valuation of Securities (E) Task Force: Consider additional company level processes in addition to using ratings. For example, a requirement for a "Structured Security Use Plan" (similar to a Derivative Use Plan) requiring insurers to have an appropriate investment and control environment prior to investing in structured securities.

17. The Rating Agency (E) Working Group will examine the extent to which insurers rely on ratings instead of performing their own due diligence.

Risk Based Capital (RBC)

18. Referral to the NAIC Capital Adequacy (E) Task Force: The NAIC's Solvency Modernization Initiative (EX) Task Force and the NAIC's Capital Adequacy (E) Task Force have been discussing reform of the RBC formulae for Life, Property and Casualty, and Health Insurers. The Working Group recommends a comprehensive review of RBC, including a review of whether all RBC formulae should have greater granularity. The focus should be on a total balance sheet approach and have a greater focus on fundamental risk analysis.

19. Referral to the NAIC Capital Adequacy (E) Task Force: Consideration should be given to recalibrate the RBC formulae to require different levels of capital for municipal, corporate and structured securities. Greater quantification of risk in these very different asset classes will permit a more appropriate distribution of capital.

20. Referral to the NAIC Valuation of Securities (E) Task Force: Continue the process of evaluating the merit of an alternative method to determine the NAIC designations to structured securities, in addition to RMBS.

Asset Valuation and Interest Maintenance Reserves

21. Referral to the NAIC Capital Adequacy (E) Task Force & NAIC Blanks (E) Working Group: The Asset Valuation Reserve establishes a reserve to offset potential credit-related investment losses on all invested asset categories. Similar to risk-based capital, greater granularity should be introduced into the AVR mechanism by introducing municipal, corporate and structured asset categories.

22. Referral to the NAIC Statutory Accounting Principles (E) Working Group: The Statutory Accounting Principles (E) Working Group should analyze whether it is appropriate to continue using changes in NAIC designations to determine if realized capital gains or losses are to be classified as interest rate gains or losses. NAIC designations are an indicator of credit quality. They were chosen as a proxy in determining whether gains or losses are interest rate related for administrative simplicity. Regulators should evaluate how well they have served as a proxy in classifying realized capital gains or losses.

References to AROs in Legislation

23. Referral to the NAIC Investment of Insurers Model Act Revision (E) Working Group: Consider encouraging state regulatorsto identify references to AROs in state insurance laws and to consider proposing modifications that refer to alternative risk assessment methods or providers so as to lessen reliance on AROs.

24. Referral to the NAIC Investment of Insurers Model Act Revision (E) Working Group: Consider whether to propose how references to AROs in NAIC Model investment laws could be retained or changed.

25. Referral to the NAIC Investment of Insurers Model Act Revision (E) Working Group: Consider whether to propose how NAIC Model investment laws could be amended to reflect the filing exempt process.

Assessing Impact of ARO Insight or Action on Insurer Ratings

26. The Rating Agency (E) Working Group should develop information that can be posted on the NAIC website to educate consumers on the limitations of rating agency ratings of insurers.

27. Rating Agency (E) Working Group: Insurers should be required to share the information provided to NRSROs, and regulators should be proactive in considering the implications of these requirements for capital and changes in ratings as a way to safeguard public confidence in regulation. We recommend the development of a model law to accomplish these objectives.

28. Rating Agency (E) Working Group: DBRS analytical process for speculative grade securities, which incorporates both the risk of default and also the likelihood of recovery in default, should be considered to assess whether a different analytical or regulatory approach to speculative grade securities owned by insurers is warranted.

29. Rating Agency (E) Working Group: AM Best indicates that certain components of its rating process related to cash flows and liquidity, risk concentration and correlation, are being enhanced as a way to assess an organization's ability to absorb tail events (i.e., low probability / high severity losses) during adverse financial market conditions. State regulators should meet with AM Best representatives to evaluate the extent to which these adjustments in the methodology signal potential complementary areas of improvement in financial regulation.

30. Rating Agency (E) Working Group: State regulators should also meet with other AROs to evaluate what improvements they have made since the September 2009 hearing on their rating processes.

VI. Recommendations for Structural Rating Agency Reform

1. Regulators should consider how to support the following reforms for rating agencies :

    a. Creating committees and processes to identify when new proposed transactions or securities do not warrant a rating. The committees would approve the logic for rating new types of securities. Determinations of such committees and the identified risks that support this determination should be made publicly available;

    b. Not only applying newer rating models for new securities, but, consistently for all applicable securities, including those in the secondary market;

c. Creating a real-time automated process that would apply a rating agency's original assumptions to the monthly servicer remittance data;

d. Disclosing monthly service remittance data or any similar underlying asset performance information publicly;

e. Creating a data library for planned transactions where details about the proposed collateral could be posted so that investors could "inspect the collateral" before purchasing a transaction;

f. Develop standards for analyst training;

g. Monitoring and using monthly servicer performance data to update/correct their initial models and assumptions;

h. Creating an Office of Chief Statistician and Models reporting to an independent committee of the board of directors;

i. A third party, who is independent from both the investment banker and the originator, should review the loans proposed for the collateral pool; and

j. Require the development of standards, greater standardization of definitions and greater consistency in the agreements used for structured securities.

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