Draft date: 03/01/2023

2023 Spring National Meeting
Louisville, Kentucky

Valuation of Securities (E) Task Force
Thursday, March 23, 2023
2:00 p.m. – 3:30 p.m.
Kentucky Convention Center—Ballroom B—Main Concourse Level

ROLL CALL

Member	Representative	State
Doug Ommen, Chair	Carrie Mears	Iowa
Eric Dunning, Vice Chair	Lindsay Crawford	Nebraska
Mark Fowler	Sheila Travis	Alabama
Lori K. Wing-Heier	Jeffrey Bethel	Alaska
Ricardo Lara	Laura Clements	California
Andrew N. Mais	Kenneth Cotrone	Connecticut
Michael Yaworsky	Carolyn Morgan	Florida
Dean L. Cameron	Eric Fletcher	Idaho
Dana Popish Severinghaus	Vincent Tsang	Illinois
Vicki Schmidt	Tish Becker	Kansas
James J. Donelon	Stewart Guerin	Louisiana
Kathleen A. Birrane	Matt Kozak	Maryland
Gary D. Anderson	John Turchi	Massachusetts
Grace Arnold	Fred Andersen	Minnesota
Chlora Lindley-Myers	Debbie Doggett	Missouri
Marlene Caride	John Sirovetz	New Jersey
Adrienne A. Harris	Jim Everett	New York
Jon Godfread	Matt Fischer	North Dakota
Glen Mulready	Diane Carter	Oklahoma
Michael Humphreys	Diana Sherman	Pennsylvania
Carter Lawrence	Trey Hancock	Tennessee
Cassie Brown	Amy Garcia	Texas
Jon Pike	Jake Garn	Utah
Scott A. White	Doug Stolte	Virginia
Mike Kreidler	Tim Hays	Washington
Nathan Houdek	Amy Malm	Wisconsin

NAIC Support Staff: Charles A. Therriault/Marc Perlman

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AGENDA

Consider for Adoption:

1. Consider Adoption of its Feb. 21, 2023, and 2022 Fall National Meeting Minutes *(Doc. ID: 2023-001.01, 2023-001.02)* *—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)*	Attachment One Attachment Two

Hear or Receive Reports:

2. Receive a Report on the Projects of the Risk-based Capital Investment Risk and Evaluation (E) Working Group —Carrie Mears (IA) and Philip Barlow (DC)	

Discuss Comments and Consider for Adoption or Re-Exposure:

3. Proposed *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) Amendment to Add Instructions for Structured Equity and Funds (Doc. ID: 2022-015.01, 2022-015.02, 2022-015.03, 2022-015.04) *—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)*	Attachment Three & Attachment Three – A–C

Receive and Discuss:

4. Next Steps for the Collateralized Loan Obligation (CLO) Modeling Project (Doc. ID: 2022.017-09) *—Carrie Mears (IA), Eric Kolchinsky (NAIC), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)*	Attachment Four

Discuss and Consider for Exposure or Referral:

5. Proposed Questions for NAIC Credit Rating Providers (CRPs) (Doc. ID: 2023-002.01) *—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)*	Attachment Five

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6. Proposed P&P Manual Amendment to Update the Notice of Credit Deterioration for the List of Qualified U.S. Financial Institutions
(Doc. ID: 2023-004.01)
—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)

Attachment Six

Receive Staff Reports:

7. Receive the Annual Report from the Securities Valuation Office (SVO) on Year-End Carry-Over Filings
(Doc. ID: 2023-003.01)
—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)

Attachment Seven

8. Receive a Report on the Projects of the Statutory Accounting Principles (E) Working Group
—Carrie Mears (IA) and Julie Gann (NAIC)

9. Discuss Any Other Matters Brought Before the Task Force
—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)

10. Adjournment

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Draft: 3/9/2023

Valuation of Securities (E) Task Force
Virtual Meeting
February 21, 2023

The Valuation of Securities (E) Task Force met Feb. 21, 2023. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Eric Dunning, Vice Chair, represented by Lindsay Crawford (NE); Mark Fowler represented by Sheila Travis (AL); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone (CT); Michael Yaworsky represented by Ray Spudeck (FL); Dana Popish Severinghaus represented by Vincent Tsang (IL); Vicki Schmidt represented by Tish Becker (KS); Kathleen A. Birrane represented by Matt Kozak (MD); Gary D. Anderson represented by John Turchi (MA); Grace Arnold represented by Ben Slutsker (MN); Chlora Lindley-Myers represented by Debbie Doggett (MO); Marlene Caride represented by John Sirovetz (NJ); Adrienne A. Harris represented by Jim Everett (NY); Glen Mulready represented by Holly Mills (OK); Carter Lawrence represented by Trey Hancock (TN); Cassie Brown represented by Amy Garcia (TX); Jon Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays (WA); and Nathan Houdek represented by Amy Malm (WI).

1. Adopted a P&P Manual Amendment to Update References to 5GI

Mears said the first item is to consider adoption of a non-substantive proposed *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) amendment to update references to 5GI. This proposed amendment was exposed for a 60-day comment period that ended Feb. 13. One comment letter was received from the American Council of Life Insurers (ACLI).

Marc Perlman (NAIC) said that at the 2021 Fall National Meeting, the Task Force adopted a non-substantive technical amendment to the Private Letter (PL) Securities section in Part Three of the P&P Manual, which clarified that an NAIC 5GI designation is the equivalent of an NAIC 5.B designation category. The Securities Valuation Office (SVO) identified other places in the P&P Manual where the 5GI.B designation category was not specified and proposed a non-substantive technical amendment to make those clarifying changes. The SVO recommends that these changes be adopted.

Mike Reese (Northwestern Mutual representing the ACLI, North American Securities Valuation Association (NASVA), and Private Placements Investors Association (PPiA)) said they are supportive of the proposed amendment.

Doggett made a motion, seconded by Clements, to adopt the P&P Manual amendment to update references to 5GI (Attachment). The motion passed unanimously.

2. Adopted a P&P Manual Amendment to Add Instructions for the Financial Modeling of CLOs

Mears said the next item is to discuss comments and consider for adoption an updated proposed amendment to the P&P Manual to include collateralized loan obligations (CLOs) as a financially modeled security in Part Four. At the 2022 Fall National Meeting, the Task Force directed Investment Analysis Office (IAO) staff to update the amendment to take into consideration the technical recommendations in the ACLI's comment letter, and then re-expose the amendment for a 15-day comment period that ended Jan. 9, 2023. One comment letter was received from the ACLI.

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Charles Therriault (NAIC) said this amendment would add CLOs within the scope of financially modeled securities in Part Four of the P&P Manual.

Like the current residential mortgage-backed securities (RMBS)/commercial mortgage-backed securities (CMBS) project, the NAIC will almost exclusively perform surveillance work for CLOs. While the Structured Securities Group (SSG) may be asked to perform some regulatory treatment analysis services (RTAS) on new issue mandates, these are expected to be extremely rare. Surveillance requires significantly less effort and will only be done once a year, along the same schedule as other financially modeled securities that the SSG already models. The actions proposed in the amendment are designed to allow insurers to continue participating in the CLO market without the risk that aggressive structuring puts policyholders and insurer investments in jeopardy.

Two comment letters were received from the ACLI. The ACLI made several constructive technical suggestions in the first comment, which the IAO substantially incorporated into the updated proposed amendment. The second comment letter, dated Jan. 9, asked about the intent of the note in the amendment stating that it was effective as of Jan. 1, 2024. The purpose of this note is to establish when the SSG is authorized to begin modeling CLO investments and provide insurers sufficient notice of this change. It is expected that insurers will follow the existing limited filing exemption (FE) for RMBS and CMBS in Part Four, paragraphs 4–5, for interim reporting. These paragraphs permit securities that cannot be financially modeled, which would be the case for CLOs until the SSG produces its first modeling output for them but are rated by a credit rating provider (CRP), to use that CRP rating to determine the NAIC designation that would be applicable under the FE procedure. Once the security is financially modeled, this limited exemption would no longer apply because it would then be a "financially modeled" security. The SVO did notice that some section titles in the amendment did not include "CLO," but the detailed instructions within that section did. With the Task Force's approval, the SVO will make those technical corrections to the final amendment.

Steve Clayburn (ACLI) thanked the Task Force for taking the concerns and suggestions in the comment letter into consideration and explaining the plan with regards to the Jan. 1, 2024, effective date and interim reporting.

Mears noted that the adoption of this finalized amendment would formalize the motion the Task Force adopted at the 2022 Fall National Meeting authorizing SSG staff to take on the CLO analytical function and request the resources it may need.

Stolte made a motion, seconded by Spudeck, to adopt the P&P Manual amendment to include CLOs as a financially modeled security in Part Four with an effective date of Jan. 1, 2024, with the technical corrections noted by Therriault. The motion passed unanimously.

3. <u>Discussed an SSG Memorandum on a Proposed CLO Modeling Methodology (Excluding Scenarios and Probabilities)</u>

Mears said the next item on the agenda is to hear comments on the SSG memorandum on a proposed CLO modeling methodology (excluding scenarios and probabilities). The modeling methodology was exposed for a 60-day comment period that was scheduled to end Feb. 13, but it was extended, at industry's request, to Feb. 17. The Task Force will be working through the substance of the details in those comments but will use this

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opportunity to have the interested parties that wrote comment letters speak, allowing immediate questions and responses so that a dialog can take place to establish next steps. Comment letters were received from:

- ACLI
- American Academy of Actuaries (Academy)
- PineBridge Investments
- Equitable, MetLife, New York Life Insurance Company, Northwestern Mutual, Pacific Life Insurance Company, Prudential Financial, and Western & Southern Financial Group (sent jointly)
- Athene, Everlake Life Insurance Company, F&G Annuities & Life, Global Atlantic Financial Group, and Security Benefit Life Insurance Company (sent jointly)
- American Investment Council
- Structured Finance Association

According to the Task Force's website, "The mission of the Valuation of Securities (E) Task Force is to provide regulatory leadership and expertise to establish and maintain all aspects of the NAIC's credit assessment process for insurer-owned securities, as well as produce insightful and actionable research and analysis regarding insurer investments."

As noted several times, it is not under the purview of the Task Force to establish actual risk-based capital (RBC) factors, and there is an initiative underway by the RBC group to address that. It is also not under the purview of the Task Force to determine statutory accounting. That would be under the purview of Statutory Accounting Principles (E) Working Group. However, it is under the purview of this Task Force to establish the credit assessment procedures and finding areas of focus that may end up involving some of those other regulatory groups. Each group has its own unique area of responsibility and expertise that the NAIC utilizes along with interdependencies between the groups.

It has been said multiple times, but it bears repeating, the SVO and SSG are not rating agencies. The Task Force has required them to provide these designations on an annual basis for use in the year-end financial statements for use by regulators in establishing RBC results, in quality assessments, and they are used in some state law provisions. The Task Force does not require them to follow the requirements imposed by the Credit Agency Reform Act, which would apply to nationally recognized statistical rating organizations (NRSROs) who take a different view in terms of an overarching surveillance process and not the annual review that is used for this narrow provision for regulators. While the Task Force relies on the SVO and SSG, there are times when it feels it is appropriate to effectively outsource that review to NRSRO when the results will be consistent with what the Task Force expects moving all the way through the NAIC framework. As noted for the CLOs, the Task Force has identified an instance where it does not feel that the existing process works throughout the entire NAIC framework. The Task Force is assessing the modeling piece for credit assessment of CLOs. The RBC assessment is being looked at by the Risk-Based Capital Investment Risk and Evaluation (E) Working Group and the groups are being collaborative with one another.

Eric Kolchinsky (NAIC) said due to the late nature of the responses, there has not been an opportunity to respond in writing yet but there will be one. Some of the comments were not responsive to the methodology, but instead just discussed the modeling process itself. One of the comments by the interested parties compared the resources at a rating agency, which rates new deals, to what the SSG does, which is a very simple surveillance process. Having previously co-managed what was called the Global Derivatives Group at Moody's Investors Service (Moody's), which included CLOs, collateralized debt obligations (CDOs), and similar products and knowing the resources

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needed for this product, the SSG is not trying to build a new issue platform, but rather a surveillance process, for which there are adequate resources. As with the current RMBS/CMBS project, the SSG does not expect to analyze any new issues. There is an RTAS process in case that is required, but the SSG currently does at most one every year. The backlog that was mentioned by one of the commenters had to do with new issue process, not surveillance. Lastly, resources are not a theoretical question. The SSG currently runs all the insurance company CLO holdings annually without any extra resources. As the regulators participating in this meeting know, the SSG produces bond-level results for them to use and put up on the Tableau worksheet. This is easily doable going forward with extra resources.

Overall, there were a lot of miscellaneous textual comments or questions. Most were very good and will included in responses in terms of detail and working through those issues in the future. The main issue that came up multiple times is that of prepayments and reinvestments. This is going to be the main issue for us working through the methodology. Prepayments are not material, but they do influence two other assumptions in the modeling: having the use of principal to pay overcollateralization (OC) tests, and, much more importantly, the par building process that is sometimes assumed. Using principal proceeds to cure OC tests is extremely expensive. Thinking about the total cost of funds for the deal, it is not expected to be used. The managers have a lot of options not to be used and do not think that is a controversial position. All that it does is switch the risk from the top to the bottom if using principal proceeds. The main issue up for discussion going forward in terms of scenarios is going to be reinvestment. Having prepayments allows principal proceeds, which can be reinvested, and if reinvested at a below par price, then par can build up. That annual ongoing par build allows the offset losses in the modeling. For example, if 20% of the portfolio repays, then take that 20%, and reinvest in something trading at a dollar price over 0.99, then there is more par and that offset approximately 0.2 times 0.1 losses in the modeling. There is some historical precedent to this, as there was a lot of par building by CLOs in the global financial crisis and during the coronavirus pandemic, and it did work out well. Part of the reason it worked out well is because of the Federal Reserve's interventions in the market, which stabilized pricing on risky assets and pushed those prices up, allowing managers to build a par and maintain a safer portfolio. It is not clear whether that assumption should continue.

It is also important to remember, for those of who were there in the past, that the process of buying securities at a discount was the death knell of the collateralized bond obligation (CBO), which was the main product before the CLO. Post the dot-com bubble, reinvested at a discount price created a downward spiral and CBOs have never recovered. This is not a universally positive thing. The SSG is not aware of any rating agency modeling these discounted purchases to build up par. If that is incorrect, the SSG requests that interested parties provide references to public NRSRO criteria that allow it to do that. The SSG's understanding is that it is not something that is modeled for by rating agencies. Next, active management is not to CLOs, so it is something that could theoretically be applied to any active pool, whether it is loans or bonds, but that was not assumed in the modeling for RBC C-1 factors. This is not something that differentiates CLOs from the standard of active management and it is unknown why it would be applied there in the first place. Lastly, Kolchinsky said that he personally has a strong conviction against this par-building mechanic based on his prior experience with CBOs and the dot-com bubble. However, part of the ACLI proposal is only to have it in certain scenarios and he is willing to explore that potentially with interested parties.

Outside of these two issues is primarily that of reinvestment and the assumption that proceeds are reinvested. This will require a greater focus on the reinvestment type assumptions: what rating, what maturity, callable schedule, etc. One of the reasons the SSG proposed a no-reinvestment assumption is because it is simpler. It does not try to overfit the model and is a very simple assumption. Again, it is stylistically better but it can be opened if there are good reasons to do so if it does not overfit the model.

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Recall that the main constraint here is the reporting equivalency between a pool of loans and the sum of all the tranches. To that extent, no matter what is discussed in terms of reinvestment assumptions, certainly, the only thing it could do is sort of shift between various tranches and risk levels within the CLO, not necessarily improve CLO performance. There is a limited usefulness of these assumptions, but again SGG is open to discussing them once the process starts going.

Lastly, Kolchinsky said there was one very reasonable comment to release all the assumptions for modeling. This has not been done because the SSG has not written the assumptions. There has been one main constraint, which is reporting equivalency. How to accomplish that is something the SSG will want to work with interested parties on. With the reporting equivalency, the SSG will continue to work with the Risk-Based Capital Investment Risk and Evaluation (E) Working Group to make sure the view of reporting equivalency is consistent. It is a process working in parallel with that Working Group and continuing communication with them.

To keep this process going and ensure transparency, the SSG would like to ask the Task Force to form an ad hoc group to model deals. The discussion so far has been about theoretics, though, at some point the idea is to nail down as much of those theoretics as possible. At the end of the day, it is going to come down to transactions and looking at those transactions and how the scenarios impact them. Making sure that is effective requires a small number of active participants going back and forth with information. Interested parties are asked to form coalitions, or at least groups, that have a single voice and can take information back to their participants. Once this process is formalized, SSG can begin looking at actual transactions and modelling actual transactions with some of these modifications and without some of the modifications so there are numbers for people to compare.

Mears said there was a lot of information to digest. As a reminder, the Task Force is not taking any actions today and will discuss the ad hoc group after hearing from interested parties on their comment letters. Everett asked if regulators can be part of the ad hoc group as well, to which Kolchinsky replied absolutely.

Clayburn said he is intrigued by the suggestion for an ad hoc group and the ACLI gives a thumbs up on that. The ACLI appreciates the fact that it was allowed to comment, and the overriding thoughts are that the assumptions should not be simplified and should be able to reflect the economic conditions of each point in time in the scenarios that are ultimately developed. The exposed methodology assumes that the non-defaulting portion of each loan matures based on the legal maturity. While commercially available models may have limitations with projecting every possible cash flow scenario, the ACLI recommends that, where practical and reasonable, modeling assumptions should capture loan features such as amortization and callability. Proposed in the letter is to replace no prepayments assumed with prepayment assumptions that vary by scenario and through time within the scenario. A chart was provided that outlines some of those scenarios for the Task Force and the SSG to consider. The letter also proposed replacing reinvestment collateral as purchased at par with pricing levels that vary by scenario and term and included a chart for which to begin the discussion. This was answered on the Task Force's last agenda item. Expected frequency of the designation modeling will be done once a year but ACLI suggests that maybe it could be done more frequently than annually.

As for assigning ratings to underlying assets, the ACLI proposes replacing the fallback assumption that uses the SVO-assigned NAIC designation category with more transparent assumption logic that all parties can instantly use because not everyone has availability to the NAIC designations. The letter suggested using the fallback logic that had been used for reinvestment assumptions that is assigned the weighted average rating factor, or, if not reported, assume it to be, for example, 4.B, which is a B3 or B rating. As for callability of bonds, CLO transactions typically include call provisions that are frequently exercised when market conditions make it economically advantageous. The ACLI suggests considering whether modeling call features would be impactful to the loss projections under the proposed modeling framework, and if so, to evaluate ways of incorporating this feature in the modeling exercise.

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Kolchinsky said loans with an amortization schedule, if available, are easy to work on and non-controversial. The things with calls, both on the loans and the tranches where there's optionality, they are just difficult to model but SSG is very much open to seeing how that works out. In terms of the annual frequency, that is the official frequent but SSG will endeavor to do unofficial ones as often as possible. The goal is to work on a detailed process that everyone knows and that is predictable. It is very important that everyone sees what is going on. Currently, what is run is the latest portfolio, as available in trustee reports, running through methodology in batches, as resources allow.

Mears said the intent once this is complete is that the methodology and scenarios are transparent enough that any user who has access to a modeling framework platform should be able to do it on their own, like a one-by-one deal. Kolchinsky said the hope is that most of the participants who responded and are sophisticated modelers should be able to replicate what the SSG is doing and provide feedback.

Steve Smith (Academy) said Kolchinsky has been transparent and engaging throughout working through the process. The comment really is more of a process-oriented comment. The Academy has been engaged with the Risk-Based Capital Investment Risk and Evaluation (E) Working Group and helping them think through CLO capital. This has involved higher-level, more conceptual issues such as what the statistical safety level should be, how it should think about the concept of RBC arbitrage, etc. As the Risk-Based Capital Investment Risk and Evaluation (E) Working Group works through those problem, they will form the basis for the objectives of any model that would then be built to assign NAIC designations to CLOs, recognizing that it's difficult to disentangle NAIC designations from RBC from C1. The comment is to acknowledge that the Academy finds it difficult to comment on any methodology to a model before the Academy knows what the objectives are. It is premature to be getting into too detailed a conversation on model methodology.

Kolchinsky said it has been great working with the Academy. It has been a mutually great relationship going back and forth. He said the goal is that RBC is the target, and the SSG works on how to reach the target. Kolchinsky said whatever targets may be provided, the SSG is happy to adjust to those.

Mears said the PineBridge Investments comment letter talks about what time frames to look out for some of the data that is being used. PineBridge Investments believes pre-2000 data is not necessarily relevant. It also points to the fact that the NAIC uses Moody's default data and recommends looking more at the Morningstar LSTA US Leveraged Loan Index. There are some other technical comments on recovery rates. Another comment is that since this is starting with CLOs, is it unfairly penalizing CLOs by going through this process that has not yet been done for other types of securitized transactions that may exhibit similar features. This is being done because there is more information on CLOs, and it is a place to start. That will take time and it is an important consideration to work through as the Task Force looks at the overall structured securities universe over time.

Kolchinsky said CLOs are clearest. One always needs to start somewhere. If the Task Force asks the IAO to look at other types, it is happy to assist. As for Morningstar LSTA versus Moody's, Moody's was used to calibrate the defaults for risk-based capital C-1 factors, so it is a consistent apples-to-apples comparison. Mears said this will go back for consideration, too, as work proceeds with the Academy.

Christopher Halldorson (Prudential Financial) said the firms listed in this letter all purchase CLOs and are strongly in support of the NAIC initiative. The firms believe the initiative is going to generate capital requirements that are transparent, consistent across asset classes, appropriately calibrated for tail risks, and designed to minimize capital arbitrage incentives. Highlighting a couple of items for consideration just because they are out there in the ether, some of them have not necessarily been brought up so far. CLOs represent a material risk to U.S. life

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insurers. That is because of the growth rate versus general accounts, the significant allocations within certain firms, and the fact that insurers are a material capital source for CLOs, in general. By some accounts, insures look like they are 50% of the mezzanine capital source. And finally, just one other point is that CLOs represent about 3–4% of life insurance holdings. That might sound small, but it is also the size that CMBS was in 2006. It is hard to look back and say that more transparency would not have been wanted in the system.

The firms on the joint letter 100% believe the SVO has the in-house modeling capabilities to appropriately model CLO for this purpose. The third-party model, transparency, stresses, and parameters used will all mean that it can be replicated. Some insurers have replicated the annual NAIC Capital Markets Bureau studies and have gotten very similar results. There may be disagreements on inputs to those stress tests but can get to the same results. This transparency is needed.

The IAO is not trying to become a rating agency and is just trying to perform a function that the rating agencies are not designed for. Rating agencies do not rate credits to the 96th percentile standard that the risk-based capital C-1 factor is designed. This is trying to fill a gap that exists. In terms of capital arbitrage, our firms interpret the no-arbitrage principle as an effort to ensure consistent capital treatment across asset classes and structured tranches. All regulators and industry participants should support that goal.

There should be caution around how one thinks about active management and diversification when getting into tail events. Most leveraged loans are financed through CLOs, so one would have to assume certain CLO managers are outperforming each other, which is a hard thing for the NAIC to do. Also on the diversification front, current C-1 bond factors incorporate the diversification of about 800 mostly investment grade issuers. The typical CLO has 200 or less issuers and mostly high yield. One must be careful about over ascribing diversification to one without looking at it in conjunction with the other. There is a lot of discussion surrounding experience on CLOs and how an experience on a BBB CLO or a BB CLO versus corporate bonds. CLO tranches are designed to have different loss experience relative to corporate bonds. This is by design; it is not good or bad. CLOs have a first loss protection built in, which is there to absorb collateral defaults when they are low. They also have embedded leverage, which can drive material losses when collateral defaults are high. This cliff risk, which the Academy described in its report, is driven primarily by systemic credit downturns, not by idiosyncratic or a few issuers' default. A systemic credit downturn has not been seen to the extent that insurers have held capital for corporate bonds over the past 20 years. That is when insurance companies have had CLOs. Extrapolating the very specific market conditions over the past 20 years that has been had for CLOs is not going to be a sufficient answer to meet RBC standards for corporate bonds held right now. Just as a reminder, the current C-1 bond factor is recalibrated using almost 40 years of default and loss experience. There is no reason to delay this work and there should be some urgency on this moving forward. CLOs should be the easiest structured asset class to model, understand, and provide consistent capital treatment and transparency to regulators.

Kimberly Welsh (Athene) said the firms included on the comment letter believe that any review must be data driven, nondiscriminatory, and result in asset capital charges that align with the risk across all asset classes. A concept called equal capital for equal risk in the letter. The firms are arguing for the appropriate amount of capital for development risk, not necessarily less capital, and believe all asset classes should be modeled and evaluated using the equivalent assumptions and methodologies. Consistency across risk and asset classes, and curve and appropriate allocation of capital and avoid inappropriate concentration from certain risks. It is unclear as to why senior secured loans are vulnerable to be knocked down only within the CLO. The approach in the comment letter is consistent with the NAIC's long-standing class process of data-driven and nondiscriminatory regulations.

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Welsh agreed with the NAIC that capital target for CLOs needs to be calibrated and thinks that if the analysis is performed on a bottom-up basis with consistent assumptions across asset charges, it will be determined that capital charges for CLOs rated investment grade will be lower than those for equivalently rated corporate debt. There is no shortage of data and studies that track the performance of CLOs, showing that they performed better and have less risk than equivalently rated corporate bonds. But beyond performance, a recent paper by Professor Robert A. Jarrow from Cornell University concluded that CLO tranche loss probabilities are, on average lower than comparably rated corporate debt. A discussion in the Academy and a recent white paper on structured debt are linked in the submission and should be considered as well.

Welsh said Kolchinsky responded to some of the concerns raised in the letter about the current ability for the SSG to dynamically model CLOs. There may be a need for more clarity on that. It is a heavy lift, and the NAIC is encouraged to more extensively evaluate the gaps in the current analysis and service of the credit reporting providers, which could be helpful in this process. Also, the letter provides technical feedback on the stress test methodology. It is difficult to provide complete feedback without understanding the full scope of the proposed changes and without certain plans for that. It would be helpful to back test the analysis and impact analysis of filing exempt (FE) ratings mapped to intrinsic price.

Mears said that this process began not quite a year ago and introduced the concept. At the time, it was within an existing RBC and designation framework and considered a different way to map those to those existing categories. This is how the concept of RBC arbitrage came up. Since then, it has been said multiple times that is not a reflection on the CLOs themselves. CLOs are not arbitrage type investments. The RBC group has since picked up reviewing the overall capital charges in general. This would effectively solve for that capital arbitrage to Smith's point earlier, as there would be something to calibrate and map to that makes sense. The comments are appreciated but to some extent they may be somewhat dated with this presumption that it would result in punitive capital charges for CLOs. That is not part of the methodology. The idea of the very highly rated CLOs having perhaps lower capital charges than corporate bonds has been on the table for a while and would likely come out of the RBC process, where ultimately that will reside. Additional commentary on this is better placed with the RBC group.

Kolchinsky said he did not have a view of the final outcome and did not want to prejudice the process. It may be possible that mezzanine AAA and AA rated tranches get a little more capital charge on this framework. Knowing the results would require knowing the probabilities, which is something that will be worked out in this ad hoc group. The overall constraint is reporting equivalency. Back testing is something that would apply to a black box model, but since this is going to be transparent, each company can run the back testing however they want. Back testing is done on a closed model to see how it does as proof and all the companies that do that work as part of the analysis.

Welsh said the second part was impact analysis. Kolchinsky said absolutely, and that as the stress tests are run, the process for stress test analysis is there. The idea is transparency so that everyone can do it and if something comes up, and it would be shared. To clarify the notching leveraged loans in the CLOs, mentioned in the technical comments, is only the rating on the loan if there is no issuer rating or no corporate rating. Those need to be mapped to default probabilities. It is very similar to what rating agencies do to take the default probability, because the rating on the loan itself, the issue rating incorporates recovery assumptions as well. There is no penalty for leveraged loans; rather, the default probability is extrapolated, similar to what is done by rating agencies.

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Mears said there were quite a few technical comments that can be taken into consideration as well as other broader comments that have been addressed in this discussion already. If something has not been addressed, it will be as the comments are reviewed.

Dallin Merrill (Structured Finance Association (SFA)) said substantively, most of the comments are from issues that have already been raised. The SFA does strive for consensus in two areas. Firstly, in eliminating capital arbitrage and supporting the NAIC and the regulators in that. Secondly, on the need for fleshing out the modeling assumptions in the scenarios. The SFA would be interested in any working groups that form to help advance that work so the modeling assumptions can be made clear.

Mears directed Kolchinsky to coordinate the creation of this ad hoc group. Task Force members can participate as they would like. For this to be a very efficient group, representatives should have the technical expertise to really work through some of these modeling processes. Additionally, the coalitions that are formed in the trade groups can put forth one person to be the communication point back to their group. Full representation is wanted, as there are some varying opinions on some of these topics, and so that the persons involved are actively engaged, and in tune with the conversations.

The modeling process is on the SSG website and not in the P&P Manual. As changes are made, they would be communicated back to this group and published on the website. The methodologies are not adopted. Once there is something that everyone can wrap their arms around, direction would be provided to continue to move forward with that methodology. For those not participating in the ad hoc group, please remain engaged with your various counterparts. The Task Force will continue to be transparent with this group about changes to that process.

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-02-21 Interim Meeting/Minutes/VOSTF 02.21.2023 Minutes v5 - (FINAL).docx

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Draft: 1/3/2023

Valuation of Securities (E) Task Force
Tampa, Florida
December 14, 2022

The Valuation of Securities (E) Task Force met in Tampa, FL, Dec. 14, 2022. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Scott A. White, Vice Chair, represented by Doug Stolte and Greg Chew (VA); Evan G. Daniels represented by David Lee; Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone and Wanchin Chou (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Virginia Christy (FL); Dean L. Cameron represented by Eric Fletcher (ID); Dana Popish Severinghaus represented by Vincent Tsang (IL); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Eric Dunning represented by Lindsay Crawford (NE); Marlene Caride represented by John Sirovetz (NJ); Adrienne A. Harris represented by Bob Kasinow and Jim Everett (NY); Cassie Brown represented by Amy Garcia (TX); and Mike Kreidler represented by Steve Drutz (WA). Also participating was: Tom Botsko (OH).

1. Adopted its October 20 and Summer National Meeting Minutes

Mears said the first item is to consider adoption of the Task Force's Oct. 20 and Summer National Meeting minutes. During its Oct. 20 meeting, the Task Force took the following action: adopted its 2023 proposed charges; 2) discussed and exposed a proposed *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) amendment to add instructions for the financial modeling of collateralized loan obligations (CLOs); 3) discussed and exposed a proposed P&P Manual amendment to update instructions for related party and subsidiary, controlled, and affiliated (SCA) investments; and 4) discussed and exposed a proposed P&P Manual amendment to clarify the definition of an NAIC Designation in Part One and Part Two of the P&P Manual.

Stolte made a motion, seconded by Kozak, to adopt the Task Force's Oct. 20 (Attachment One) and April 5 (*see NAIC Proceedings – Summer 2022, Valuation of Securities (E) Task Force*) minutes. The motion passed unanimously.

2. Exposed an Updated Proposed Amendment to the P&P Manual to Include CLOs as a Financially Model Security in Part Four

Mears said the next item is to discuss comments for a proposed amendment to the P&P Manual to include CLOs as a financially modeled security in Part Four.

Eric Kolchinsky (NAIC) said the proposed amendment would add CLOs, a type of structured security backed by a pool of debt with corporate loans of very low ratings within the scope of financially modelled securities in Part Four of the P&P Manual. It is NAIC staff's opinion that an insurer that purchases every tranche of a CLO holds the exact same investment risk as it would if it had directly purchased the entire pool of loans backing the CLO. Like the current residential mortgage-backed securities (RMBS)/commercial mortgage-back securities (CMBS) project, the NAIC would almost exclusively perform surveillance work for CLOs and be asked to perform some regulatory treatment analysis services (RTAS), which is the full-on initial analysis of a deal, but this is not expected often. Hence, there will be a lot less effort than what would normally be required by a rating agency. This would also be performed once a year, similar to the RMBS/CMBS project, which is primarily yearend.

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The Investment Analysis Office (IAO) recognizes the importance of CLOs to the financial markets, and this amendment does not diminish the role of insurance companies and their investments in the U.S. economy and financial markets. Nevertheless, the main priority of state insurance regulation are policyholders and ensuring that they are protected through prudent financial solvency policies. The actions contemplated are designed to allow insurers to continue participating in the CLO market without the risk that aggressive structuring puts policyholders and insurance investments in jeopardy. One comment letter was received from the American Council of Life Insurers (ACLI). It made several constructive technical suggestions. The IAO staff requests the Task Force defer adopting the amendment today to permit the amendment to be updated with most of those recommended changes. An effective date of Jan. 1, 2024, for the change is recommended with the first reporting year-end being Dec. 31, 2024. That will provide sufficient time to develop the scenarios and methodology and report back to the Task Force, as well as using 2024 to give insurers information about what the results would be at year-end. A brief 15-day comment period is requested for this re-exposure.

Michael Reis (Northwestern Mutual representing the ACLI) said that the ACLI is fine with the 15-day comment period. Mears directed IAO staff to update the amendment, taking into consideration the technical recommendations in the ACLI's comment letter, and re-expose for a 15-day comment period ending Jan. 9.

Mears said the point of this amendment was to ensure that the Structured Securities Group (SSG) team has the resources it needs to start working on this project.

Stolte made a motion, seconded by Cotrone, to authorize the SSG staff, pending finalization of this amendment, to take on this CLO analytic function and formally request the resources it may need. The motion passed unanimously.

3. Adopted an Amendment to the P&P Manual Updating Instructions for Related Party and SCA Investments

Mears said the next item on the agenda is to discuss comments and consider adoption of a proposed amendment to the P&P Manual to update instructions for related party and SCA investments.

Marc Perlman (NAIC) said this agenda item stems from a referral from the Statutory Accounting Principles (E) Working Group. On June 10, 2022, the Working Group sent a referral to the Task Force resulting from the Working Group's May 24, 2022, adoption of agenda item 2021-21: Related Party Report. The agenda item revised both *Statement of Statutory Accounting Principles (SSAP) No. 25—Affiliates and Other Related Parties* and *SSAP No. 43R—Loan-Backed and Structured Securities*, which raised comments about eligibility for filing exemption (FE) for various affiliated structures. The Working Group's amendment required new reporting information for investments that involve a related party as sponsor, originator, manager, or other similar transaction party, regardless of whether the investment is captured on the affiliate reporting line.

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

The Securities Valuation Office (SVO) proposes amending SCA section of the P&P Manual in the several ways. First, clarify that the section captures not only SCA investments, which are determined by control, but also *related party investments,* which include various other relationships between an insurer and transaction party. The related party example given during the Task Force's Oct. 20 meeting was an example the SVO saw of a familial, father-son relationship between the owner of the issuer and the chief executive officer (CEO) of the reporting insurance company. Second, amend the section so that investments with direct or indirect credit exposure to an SCA or related party of the insurer, whether as an issuer or otherwise, would be *ineligible* for FE. And third, investments

with an SCA or related party entity in the transaction structure but with *no* direct or indirect credit exposure to those entities (such as an issuing special-purpose entity [SPE], sponsor, originator, manager, etc.) would be FE unless otherwise ineligible for FE pursuant to P&P Manual guidance unrelated to SCA or related party status. However, the proposed amendment is clear that state insurance regulators can, in accordance with Part One of the P&P Manual, require an insurer to file an otherwise FE investment with the SVO for analysis and/or assignment of a designation, making that security ineligible for future FE.

A joint comment letter was received from the ACLI, the Private Placement Investors Association (PPiA), and the North American Securities Valuation Association (NASVA) that was generally supportive of the intent of the amendment but requested certain technical changes to better clarify that intent (Attachment 4-A). The SVO would recommend accepting those changes with the following edits:

In Part Three, paragraph 4, subclauses (1) and (2), the SVO recommends inserting the words "direct and indirect" prior to "credit risk exposure"; inserting "whether as issuer or otherwise" after "SCA or related party"; and moving the parenthetical "(each, as defined in this part)" to subclause (1) and in that subclause, spelling out in its entirety the terms "SCA and related party bond and preferred stock investments" so that the first sentence reads: "SCA and related party bond and preferred stock investments are comprised of two types of transactions: (1) SCA and related party bond and SCA and related party preferred stock investments (each, as defined in this Part) that have direct or indirect credit risk exposure to the SCA or related party, whether as issuer or otherwise, which are not filing exempt; and (2) SCA and related party investments that do not have any direct or indirect credit risk exposure to the SCA or related party, whether as issuer or otherwise, which are filing exempt."

In paragraph 247, the SVO recommends changing the term "credit exposure" to "credit risk exposure" to make it consistent with other references, adding the words "direct or indirect" prior to the references to "credit risk exposure" and, in subclause (ii), removing the word "underlying" with regard to the investment and changing the reference to "affiliates" to "SCAs."

There are two additional clean-up edits proposed: 1) in paragraph 248, inserting the word "stock" after "preferred"; and 2) as with paragraph 247, changing the references to "affiliated" to "SCA and related party."

Deborah Casey (Global Atlantic Financial Group representing the ACLI and NASVA) said the process was collaborative, making these changes along with other additional clarifications, and that they are satisfied with the results.

Stolte made a motion, seconded by Crawford, to adopt the amendment to update the instructions for related party and SCA investments with the technical revisions that Perlman presented (Attachment). The motion passed unanimously.

4. <u>Discussed Comments for a Proposed Amendment to the P&P Manual to Clarify the Definition of an NAIC Designation in Part One and Part Two</u>

Mears said the next item on the agenda is to discuss comments received on a proposed amendment to the P&P Manual to clarify the definition of an NAIC designation in Part One and Part Two. These clarifications are to recognize that NAIC designations are a specific risk measure created solely for NAIC regulatory purposes. The updates being proposed to Part One and Part Two are intended to further emphasize that NAIC designation are specifically intended to reflect their use in the NAIC's Financial Regulation Standards that have been incorporated into state law by the states as participants in the Accreditation Program. The amendment also intends to make the definitions consistent between these two parts of the P&P Manual.

Comment letters were received with some good suggestions and observations from the Capital Adequacy (E) Task Force and its risk-based capital (RBC) working groups. The comments indicate that additional work is needed by the Task Force to clarify the meanings for regulatory purposes. This will be an evolving process, but the Task Force will keep working on it.

Charles Therriault (NAIC) said the general purpose of NAIC designations, administered through the SVO, is to ensure that investments in securities made by state-regulated insurance companies are assessed according to objective and reasonably consistent standards for credit quality to accurately reflect those companies' financial solvency as required by state statutes. While some NAIC designations are assigned through the filing process relying upon a credit rating provider (CRP) rating, mapping to a corresponding NAIC designation, the mere fact that a CRP rating could be converted to a NAIC designation does not mean that the two are interchangeable. The proposed added language triers to clarify three issues that the SVO encounters regularly:

- An NAIC designation reflects the likelihood of timely payment of principal and interest, as appropriate, and the probability of principal and interest payment default.
- An NAIC designation reflects the appropriateness and consistency of the RBC model factor that will be applied to the security given its level of risk.
- An NAIC designation must be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS).

The proposed updates are not new principles and are consistent with existing policy statements by the Task Force. For example, in Part One, paragraph 89, the definition of an NAIC designation category states that it: "Means and refers to 20 more granular delineations of credit risk in the NAIC 1 through NAIC 6 credit risk scale used by the VOS/TF to relate credit risk in insurer-owned securities to a risk-based capital factor assigned by the NAIC Capital Adequacy (E) Task Force."

The subsequent paragraph 90 in Part One adds that: "An objective of the VOST/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain."

In Part Two, paragraph 160, the definition of credit ratings eligible for translation to NAIC designations requires the rating to "apply to securities where the issuer promises to repay principal and interest or dividends" and "convey an opinion as to the likelihood of payment of both principal and interest/dividends due from the issuer to the holders of the security."

To be clear, the Valuation of Securities (E) Task Force is in no way responsible for the assignment of RBC factors to any band of investment risk. However, NAIC designations are often used as an indication of risk in several NAIC processes, and it would be inappropriate for the Task Force to ignore how its work is used in other NAIC regulatory processes.

Three comment letters were received. The first was from Anderson Insights, which indicated support for the concept of clarifying the definition of NAIC designations and eliminating unnecessary language in the P&P Manual. The SVO agrees with that general objective and has made several efforts to improve the clarity of the P&P Manual over the past several years, including a full rewrite in 2018, and it is willing to continue to do so.

The second was a joint comment letter from the ACLI, the PPiA, and the NASVA. The letter also indicates that there could be additional improvements to clarify the purpose of NAIC designations and the connection between Part One, policies of the Task Force, and Part Two, the operational and administrative instruction to the SVO.

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The third letter was from the Capital Adequacy (E) Task Force and its RBC working groups. As noted in their letter, these groups are responsible for the assignment of RBC factors to any band of investment risk. That is not the job of this Task Force.

The SVO did not want to propose substantial changes with this amendment. However, if the Task Force wishes, a more holistic review of the guidance in the P&P Manual can be conducted, and a revised amendment addressing these issues can be brought back to the Task Force. It will likely be a more substantial amendment.

Mears said it is important that the Task Force move forward with clarification of these definitions as it provides a foundation for what future actions would be. There is not a particular action or result that would come from the NAIC designation definitions themselves, but it helps to underlie future discussions or proposals that the Task Force may have. As an example, within the Statutory Accounting Principles (E) Working Group, there was a discussion about the interest maintenance reserve (IMR), and one of the key concepts behind that is the role of conservatism in statutory accounting. That is the concept that underlies the guidance. It does not result in an automatic answer with what to do with the IMR, and there will be a fulsome discussion of how to approach that going through the NAIC's normal due process, but it uses that concept of conservatism underlying it. That is a model of what the Task Force would look at as it creates these clarifications for what an NAIC designation means and provides an underlying framework on how to make future proposals or future assessments in assessing investment risk with the directions of the Task Force to the SVO. There are several changes needed to make that process clearer.

Reis said it is hard to argue that an NAIC designation should be consistent with the investment RBC factors. The ACLI wanted to raise questions of what the practical implications of that mean, and similarly with the changing of the notching language. The ACLI supports what was proposed.

Christopher Andersen (Andersen Insights) said he supports the idea of clarifying the definition and simplifying it. The comment letter submitted has specific proposals. There are three spots in the P&P Manual that define designations that can be consolidated. Part of clarifying the meaning of designations is to understand what designations are and are not. The regulatory interest and investor interest are in payment and payment as promised. If something does not pay as promised, and a bond is a promise to pay, that is default— something that is measured by credit ratings. A typical bond structure of a 10-year bond with a 5% coupon is a bond, and in 10 years, it will pay interest semiannually. A zero-coupon bond is a bond that may be a little riskier because the investor does not get the principal and interest until the end of the term. But they are both bonds. An analyst would look at those and look at the ability of the borrower in terms of their assets and cash flow, and their ability to meet the terms and conditions of the bond. What is seen in the P&P Manual is a reference to other risks of nonpayment. Some securities are assigned a subscript to indicate that there is other risk of nonpayment. Andersen said that his understanding is that risk of nonpayment is credit. The reason the investor is not paid is because the investor is unwilling or unable to pay, and that is default. That is a fundamental element to NAIC designations.

The P&P Manual does refer to other risks of nonpayment, so what could those be? If a bond performs and if the promise is fulfilled and the investor gets paid as promised, how can there be other disruptions? There are three examples. One is a callable bond. The same 10-year bond with a 5% coupon has a call in five years. The investor looks at that and can either book the five-year coupon or the 10-year coupon. The convention in the marketplace for a callable bond is that it is priced at the yield to worst. That means, from the investor's point of view, assume that the worst thing will happen. And depending on the call premium, in most instances, the worst thing that can happen is the bond will be called. If an insurer is expecting, hoping, or anticipating a 5% coupon for the back end of that transaction, they may get it for the final five years, but they may not. A conservative way of looking at that is to assume that it will not.

Another example is paid-in-kind (PIK). If the issue has the ability to pay the investor interest, or pay in more bonds/PIK, then the investor can assume that it will be paid, say, a 6% rate of interest for the entire term, or the investor can assume that it will essentially become a zero-coupon bond. That is the investor's choice. The conservative approach is to assume that the investor will be PIK, just as the conservative approach to looking at a callable bond is to assume that it will be called, and the investor will be disadvantaged.

A third example is a 1% 10-year bond, and all it pays is 1%, except if Tampa Bay wins the Super Bowl, then it is a 10% bond. The analyst must look at that and assess if this issuer can support a 10% coupon. Does it have the resources? That will affect the credit rating, probably adversely because of the hefty coupon, but the promise is the promise. In that instance, the issuer needs to assume that it might have to pay 10%, but the insurer should assume it pays no more than 1%. How is this operationalized? This is a basic concept that separates the notion of an NAIC designation and calls it basically credit ability and willingness of the borrower to pay. But the fine print is to pay what is promised. There is no promise to pay more than five years for the callable bond. There is no promise that a bond will not PIK. There is no promise that one will get a windfall. The rating tells the probability of that happening.

There are several ways that this can be operationalized. One way is to assume the worst. Another is that these are embedded options, either long or short, and they are optional provisions that the issuer controls. It is theoretically possible to value those options, but that would be difficult and would involve a lot of coordination. The question is how anything like this is advanced, and a discussion is needed with the Capital Adequacy (E) Task Force because, as has been mentioned, the RBC factor drives RBC in several respects. However, the idea of using the worst possibility, where there is an option on the behalf of the issuer, using the worst possibility, one could maybe justify notching, but that is far-fetched. If one reported the worst, things would be transparent. Instead of taking a callable bond and making an adjustment, if it is reported on the books and records as if it were called, then one has a more transparent situation than if one tried to adjust another metric. Andersen said that he does not see anything immediate that can happen and hopes this is brought into the discussion. He said as the Task Force looks at how an NAIC designation is supposed to be defined, he hopes that some of those considerations can be incorporated.

Mears said the last comment letter was from the Capital Adequacy (E) Task Force and its RBC working groups that are asking for the Valuation of Securities (E) Task Force to ensure that there is clarification that clearly it is not the role of this Task Force to establish RBC, but rather to provide valuable NAIC designations into that process. Botsko said that as the second letter indicates, the Capital Adequacy (E) Task Force and the RBC groups appreciate the follow-up discussion. With a better understanding of the intent that wished to be conveyed through that the additional language, these groups look forward to working with the Task Force on language that will suit everyone's needs.

Mears deferred action on this P&P Manual amendment to clarify the definition of an NAIC designation in Part One and Part Two at this time. She directed NAIC staff to continue to review the recommendations made in the letters and to work with the Capital Adequacy (E) Task Force to improve the verbiage and potentially make some other changes. The updated amendment will be brought back to the Task Force for further consideration.

5. <u>Exposed a Proposed P&P Manual Amendment to Add Instructions for Structured Equity and Funds</u>

Mears said the next item on the agenda is to discuss and consider exposure of a proposed P&P Manual amendment to add instructions for structured equity and funds. The SVO has processed several private letter rating (PLR) filings for investments in notes issued by a special purpose vehicle (SPV), trust, limited liability company, limited partnership, or other legal entity that operates as a feeder fund, which itself invests, directly or indirectly, in one or more funds or other equity investments. The SVO is concerned about this general structure that it is calling structured equity and funds because it can circumvent regulatory guidance from this Task Force,

the Statutory Accounting Principles (E) Working Group, and the Capital Adequacy (E) Task Force. It is enabled by the NAIC's reliance on rating agency ratings and permits potential RBC arbitrage given the role of the equity piece being treated as bonds. It ultimately lacks regulatory transparency because of the multiple layers of private entities and private ratings.

Mears said within the memorandum that was written, it notes that the Statutory Accounting Principles (E) Working Group has a bond project in place that will address how these are treated as bonds. That is a future state, presuming that moves forward as written, and it will not be implemented for a couple of years. There will be a wider universe of applicability in this amendment until that time where that bond universe would effectively shrink due to the Statutory Accounting Principles (E) Working Group bond projects coming into place. There is an interim impact to this and then maybe more of a long-term impact. The Task Force recognizes that many of these structures are clearly valid, but this amendment is looking for more transparency in order to differentiate between them.

Therriault said equity and fund investments that are structured through another legal entity have been able to qualify as bonds under the current regulatory definitions due to their legal form instead of substance as with the proposed bond definition before the Statutory Accounting Principles (E) Working Group. The investments are able to bypass the reporting requirements for equity and fund investments. These structures have sometimes been referred to generically as "rated notes," but they may be called other names. The general framework typically is based on an equity or fund investment, but they could just as easily be based upon any asset, including those of affiliates or non-admitted assets. These assets are being "transformed" into what the insurer reports as a bond through the insertion of an intervening legal entity, which issues a note that, due to a CRP rating, receives the statutory treatment of a bond for accounting, reporting, RBC, and NAIC designation purposes. This process exploits the inherent weakness within the FE process whereby anything with a CRP rating is assumed to be a "bond" and automatically treated as such despite its underlying assets, structure, or risk. These transactions can also permit the deferral of interest and/or principal payments, sometimes without capitalization and without being an event of default, introducing additional other nonpayment risks not reflected in the CRP ratings used in the FE process.

It is possible that many of the transactions the SVO has processed would not qualify as bonds eligible for Schedule D-1 reporting according to the principles-based bond definition currently being drafted by the Statutory Accounting Principles (E) Working Group, while others likely will qualify. The use of a fund intermediary has the potential to be abused and requires significant judgment to understand the substance and nature of the ultimate underlying risk. This has already been recognized by the establishment of processes for the SVO to provide NAIC designations for fixed-income-like funds. It would then follow that debt instruments backed by the types of funds that would ordinarily be required to be filed with the SVO should follow the same process.

In the two examples included in the memorandum accompanying the amendment, the SVO walked through the structures, how the substance of the investment would have been treated if the insurer invested in it directly, how the actual investments issued would be treated, and the potential relative RBC impact of using the CRP rating for a structured equity and fund. In each example, assets that would not ordinarily be permitted to be reported as a bond were eventually filed as a "bond" after passing through an intervening legal entity to change the legal form but not the substance of the risk. They both received highly favorable private ratings from two different rating agencies. In the first example, an insurer relying on the CRP rating translation into an NAIC designation would be able to potentially reduce the implied RBC factor for the investment from 9.5% to 4.1%, a reduction of 56.6%. In the second example, an insurer relying on the CRP rating translation into an NAIC designation would be able to potentially reduce its implied RBC factor for the investment from 30% to 3.35%, a reduction of 88.8%.

As mentioned earlier, the Valuation of Securities (E) Task Force is not responsible for the assignment of RBC factors to any band of investment risk; that is the sole responsibility of the Capital Adequacy (E) Task Force and its RBC

groups. However, it is the reasonability of this Task Force to ensure that the assignment of an NAIC designation to any investment appropriately reflects a reasonable assessment of its credit risk. As these examples demonstrate, that is not currently occurring with structured equity and fund investments.

The FE process facilitates obscuring these investments with nondescript issue descriptions such as "senior notes" or "term loans." The multiple layers of private entities involved, coupled with private ratings, removes any transparency. A state insurance regulator would have no way to know by looking at the information available on Schedule D that these are complex structures investing in assets that could include affiliate investments, non-fixed income investments, derivatives, borrowings for the purpose of leverage, and non-admitted assets.

Given the magnitude of the potentially multiple regulatory arbitrage opportunities, the judgment involved in assessing the nature of the ultimate risk, the lack of transparency, circumvention of regulatory guidance, and the reliance on CRP ratings to accomplish these ends, the SVO proposes amending the P&P Manual to add a definition for structured equity and fund and to exclude such investments from FE eligibility. The proposed amendment would not change how the investment is classified for reporting by the insurer, but it would ensure that the NAIC designation and category assigned to it reasonably reflect the credit risk for NAIC purposes.

Mears said as the Task Force reads through the amendment during the exposure period, know that the potential procedure recognizes that there are quite a few underlying asset types that could be in these funds, and there may not be methodologies within the SVO to review them. The use of a CRP rating and getting the rating report may be used in many of these cases for review. That is in the proposed amendment, recognizing that that there could be a wide variety of assets and that the process would help create more of a validation around that CRP rating, with the ability to understand what those underlying assets are, effectively remove some of the lack of transparency that exists today, and look at what the underlying risk is of those assets.

Mears directed NAIC staff to expose the proposed amendment to add instructions for structured equity and fund investments for a 60-day public comment period ending Feb. 13, 2023. She directed NAIC staff to provide an informational referral to the Capital Adequacy (E) Task Force, given some of the components that are impactful to RBC.

6. Exposed a Proposed P&P Manual Amendment to Update References to 5GI

Mears said the next item on the agenda is to discuss and consider for exposure a non-substantive proposed P&P Manual amendment to update references to 5GI.

Perlman said that at the 2021 Fall National Meeting, the Task Force adopted a non-substantive technical amendment to the private letter rating securities section in Part Three of the P&P Manual, which clarified that an NAIC 5GI designation is the equivalent of an NAIC 5.B designation category. The SVO has identified other places in the P&P Manual where the 5.B GI designation category is not currently specified and proposed a non-substantive technical amendment to make those clarifying changes.

Mears directed NAIC staff to expose the proposed amendment to update references to 5GI for a 60-day public comment period ending Feb. 13, 2023.

7. Exposed an SSG Memorandum on a Proposed CLO Modeling Methodology (Excluding Scenarios and Probabilities)

Mears said the next item is to receive and consider exposure of an SSG memorandum on the proposed CLO modeling methodology.

Kolchinsky (NAIC) said that phase one of the process was to receive authorization, which was handled in the earlier agenda item two. This will permit starting the internal process to get the project going. Next is to discuss phase two of the project, which is the methodology, and then there will be phase three, which is the scenarios and probabilities modeling assumptions. The point of phase two is to set up the mechanics of the modeling. Hopefully, there are not too many controversial things in phase two, but the idea here is to set up modeling assumptions that are to be used so once this project gets to phase three, anyone can repeat the kind of work that is being done and get the same numbers so that everyone is speaking and working on the same page in terms of the scenarios and probabilities. If these modeling assumptions are set up, then the SSG can focus on the scenarios and probabilities, which will probably be a harder issue and more controversial as the other easier items will already be taken care of.

Included in the memorandum is an annex with all the assumptions. The SSG is asking interested parties and anyone else who wishes to comment three questions. First, are there any other assumptions, with the goal for complete transparency into the process, assuming that the default vector is known so there is a recovery assumption. What other information needs to be set up to make the modeling possible? Not everything may have been captured, and feedback is appreciated. Next, regarding the assumptions that have been listed, are they reasonable? Take out the default assumptions and recovery assumptions that will be talked about in phase three. Other than that, are these reasonable? There will also be an opportunity to comment on those together. And lastly, are there any other issues on any assumptions that would need to be taken care of?

If there are alternative assumptions presented or if there are any questions or unreasonableness of the assumptions that have been put into the annex, the SSG is asking for three things. The first is an actionable alternative, meaning something that that can be replicated not just by the interested party, but also by the whole market. If it is based on a proprietary model, which the participant does not intend to share, that is not something that is actionable. That is something that that can be replicated and by anyone in the market. Second, the SSG would like to see a quantitative justification for that assumption and a broadly historical justification as well, broader than the market expansion from 2011 to 2019. And lastly, the SSG would also like to ask that if there are any references to the suggestion in rating agency methodologies, if those could be referenced as well.

Chou asked about the modeling methodology. He asked that because a CLO is a complicated investment, is the SSG planning to work with other groups. He said that both the Life Actuarial (A) Task Force and the Risk-Based Capital Investment Risk and Evaluation (E) Working Group are working on this. The methodology, including the probability and scenarios, essentially is a stochastic model, mentioned in phase two and phase three. He said that in the past, there was bounce back and counter-discussion in the later stage that may cause more confusion if they are not included earlier.

Kolchinsky said the assumptions in phase two are just generic assumptions, which are normally used for modeling CLOs. The SSG is happy to work with Risk-Based Capital Investment Risk and Evaluation (E) Working Group and has had in-depth discussions with the American Academy of Actuaries (Academy) already and built a good relationship with them. The SSG is also happy to work with any other groups, such as the ones that have been mentioned at this stage. The scenarios will likely be more controversial. There have been good interactions with the Risk-Based Capital Investment Risk and Evaluation (E) Working Group, and several presentations have already been made to the Working Group. The SSG will keep it updated as work on this proposal continues. These are generic cash-flow assumptions that are not to converse in terms of how the market runs models for CLOs. Kolchinsky said that phase three is where the rubber meets the road.

Mears said Kolchinsky is involved with the Risk-Based Capital Investment Risk and Evaluation (E) Working Group with these presentations. The Academy had presented some of its initial comments on the potential for new C1 factors this morning. It is interconnected with this project. The modeling on its own is distinct, just like the setting

of the C1 factors is distinct, but they obviously have an interconnectivity that needs to be worked through as to what the implications are to both sides, so they do not operate in silos by any means.

Mears directed NAIC staff to expose the proposed CLO modeling methodology for a 60-day public comment period ending on Feb. 13, 2023.

8. Received a Report on the Projects of the Statutory Accounting Principles (E) Working Group

Mears said the next item is to hear a report on projects before the Statutory Accounting Principles (E) Working Group.

Julie Gann (NAIC) said that as part of the coordination efforts to identify key things investment-related that may be of interest to this Task Force and interested parties, the Working Group had several items that were adopted or exposed yesterday during its meeting. She said the first adoption was simple; the Working Group adopted revisions to clarify that foreign open-ended investment funds is a type of fund in which the ownership interest is not deemed to reflect control unless the reporting entity actually has the power to direct the underlying company. That is consistent with guidance that already exists for exchange-traded funds (ETFs) and mutual funds, but it just did not have foreign open-ended investment funds included in the mix.

The Working Group adopted revisions to the derivatives standard. That has been done twice this year and then previously back in 2018 to become more converged with U.S. generally accepted accounting principles (GAAP) with regard to the assessment of derivative effectiveness. Those revisions are effective Jan. 1, 2023, and early adoption is permitted. This is being highlighted to this Task Force because the SVO bond-identified ETFs have a factor or component with regard to derivatives. Not being well versed in that guidance, the reason to highlight the derivative guidance change is to make sure that the Task Force is aware of it in case it must be considered with regard to that current guidance.

Gann said there are seven quick items to highlight for exposure. She said that all the comment deadlines for these exposures is Feb. 10, 2023 (three days prior to the Valuation of Securities (E) Task Force comment deadline) and again intended to give a little bit more time for the year-end reporting that occurs March 1. First, there is an exposure to expand the statutory accounting guidance for tax equity investments. That is a broad term that is being used right now. There is guidance in *SSAP No. 93—Low-Income Housing Tax Credit Property Investments* for low-income housing tax credits. There are other types of tax credit investments out there, but right now there is limited guidance for those specific name situations. This is a broad proposal to expand that guidance to encompass all tax equity investments that qualify in certain criteria. A discussion paper was exposed, and there is also an agenda item that really focuses on new market tax credits. Everyone is encouraged to review the discussion paper, which goes beyond new market tax credits. The Working Group would like to get information from industry as well as state insurance regulators, particularly on state-specific situations that exist.

There is the item that was mentioned earlier called the IMR. An agenda item was exposed regarding that topic. For those who may not be aware, IMR focuses on interest-related gains and losses because of sales of bonds. It is a hot topic right now. As a result of the Working Group's conversation with the exposure, a request was made to industry to provide some potential guardrails and details on unique considerations, and the Working Group directed NAIC staff to coordinate regular discussion with the Life Actuarial (A) Task Force. If there are states that are considering permitted practices with regard to this topic, there will also be a state or regulator-only memorandum for things to consider as part of that process.

Next, with regard to collateral loans, the Working Group exposed guidance, which is a re-exposure, to clarify that the underlying collateral must qualify as an admitted asset for the collateral loan to be admitted. This is an agenda item that is trying to be converged with the guidance on SSAP No. 20—Nonadmitted Assets, which has a small

section on collateral loans, and *SSAP No. 21R—Other Admitted Assets*, which also has a section on collateral loans. The discussion really focused on *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* type investments because those are required to be audited for admittance under statutory accounting. The question is whether they need to be audited in order for the underlying collateral for a collateral loan to be admitted.

Also, with regard to SSAP No. 25, guidance was exposed to clarify that any invested asset held by a reporting entity that is issued by an affiliated entity, or that includes the obligation of an affiliate entity, is an affiliated investment, and that is a follow-up for the related party guidance that was adopted earlier this year.

There is a new exposure for investment income due and accrued. This item predominantly data captures the current disclosure for interest income in *SSAP No. 34—Investment Income Due and Accrued*, but it does expand it slightly to capture information on PIK interest that is included in the current principal balance. This will also have a corresponding blanks proposal so that data can be captured information for 2023.

The Working Group also had an exposure related to working capital finance notes, which is a topic that has been shared with the Task Force over time. This is a little bit different. The U.S. Financial Accounting Standards Board (FASB) issued guidance related to these supplier program financing arrangements, but it was focusing on the creditor, and it incorporated new disclosures for those creditors in the U.S. GAAP financial statements. If the entity is the "Walmart" of the program and using these finance arrangements, right now there is inconsistency on how that is reported, with some companies reporting it as trade payables and other companies reporting it as debt. These are not disclosures that would be relevant to the reporting entity in their involvement because they are the investor in these programs. However, it may be something that would be worthwhile for companies that are looking to be investors in those programs, but for statutory, this was exposed to reject those disclosures.

The last exposure has to do with the bond proposal project. The Working Group exposed reporting revisions to detail going back to the Schedule-D general instructions and then the Schedule D-1-1 and the Schedule D-1-2, which is a new schedule. Interested parties' comments were considered and reflected and in the updated documents exposed for comments. Also exposed was a new issue paper, as well as reporting changes. NAIC staff have gone through all the blanks annual statement instructions and identified all instances in which bonds or loan-backed structured securities or anything that could be affected by these and identified recommendations for the revisions. It is extensive, for the most part. Because there are changes to reporting lines, there are a few schedules that will be significantly revised, such as the summary investment schedule, summary by country, and the Schedule D, Part 1A, which was exposed for comment. Earlier in November, the Working Group exposed updated statutory accounting revisions for the bond project, *SSAP No. 26R—Bonds* and *SSAP No. 43R—Loan-Backed and Structured Securities*. It is a document similar to the reporting one just mentioned where it goes through all the SSAPs and identifies other revisions that need to be reflected for the bond project.

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

Kolchinsky provided an update on the regular RMBS/CMBS year-end deliveries that should happen sometime between Dec. 16 and Dec. 20, with Dec. 19 being the most likely day for phase one delivery.

Mears said the Task Force has other initiatives that are still underway, even though maybe they have not been talked about in some time. There is always a lot of interest in the review of CRPs. There had been a small group that worked through some of these issues during 2022. That group will no longer meet because the Task Force is ready to move forward more in a regulator-only format and create a list of questions to start preliminary conversations with those CRPs. She said to anticipates seeing that kind of detail on upcoming agendas in 2023 as the Task Force moves forward with that process. Some of the other areas where the Task Force is looking at changes may be on hold as it figures out the NAIC designation definition and then circles back to see how those

changes fit in from an overarching perspective. She told the Task Force that if there is anything else that has been on their radar that has not been addressed recently, feel free to reach out, and updates can be provided.

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

TO: Carrie Mears, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

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

RE: Proposed Amendment to Define and Add Guidance for Structured Equity and Funds to the P&P Manual

DATE: November 28, 2022

Summary – The SVO has processed several private letter rating (PLR) filings for investments in notes issued by, and of equity or limited partnership interests in, a special purpose vehicle, trust, limited liability company, limited partnership or other legal entity that operates as a feeder fund which itself invests, directly or indirectly, in one or more funds or other equity investments. The SVO is concerned about this general structure for the following reasons:

1) Circumvent Regulatory Guidance - With the introduction of an intervening entity as debt issuer, if the investment is in substance an equity investment, the format of the investment circumvents regulatory guidance established by this Task Force, the Statutory Accounting Principles (E) Working Group and the Capital Adequacy (E) Task Force for the reporting of equity investments unless, in the case of funds, the SVO determines that the fund produces fixed-income like cash flows and is therefore eligible for specific classification, and that equity and fund investments are ineligible to use credit rating provider (CRP) ratings in the assignment of an NAIC Designation.

   All non-SEC registered funds are required to be reported on Schedule BA. Life insurance entities are permitted to file investments in private equity funds, partnerships, limited liability companies and joint ventures to the SVO for specific classification on Schedule BA.;

2) Reliance on Ratings - These investments are being reported as bonds and receiving a bond risk-based capital (RBC) factor based upon the mechanical assignment of NAIC Designations that rely upon Credit Rating Provider (CRP) ratings through the filing exempt process. The use of CRP ratings would not be permitted for the fund or equity investments which underly these notes if the equity or fund investment were held directly;

3) RBC / Investment Limit Arbitrage - The structure may permit in-substance equity and fund investments to obtain improved RBC treatment than what would be received if the investment had been directly reported. In addition to improved RBC treatment, the structures could permit entities to hold more underlying equity / fund investments than what would be permitted under state investment law; and

4) Transparency - The structures typically use two or more interconnected non-public private entities through which the non-public and privately rated "bond" securities are issued that are backed by investments in non-public assets. The many non-public private layers deny regulators, and possibly insurer investors, transparency into the true underlying risks, credit exposure and nature of the investment. The notes issued are described generically as a "senior note" or "term loan" further obscuring their actual structure and complexity. These structures can invest in any asset including affiliate investments, non-fixed income investments, derivatives, borrowings for the purpose of leverage and non-admitted assets.

It is possible that many of the transactions the SVO has processed would not qualify as bonds eligible for Schedule D-1 reporting according to the principles-based bond definition currently being drafted by the Statutory Accounting Principles (E) Working Group, while others likely will qualify. The bond definition requires a review of the substance of the investment to determine whether it has the substance of a bond; most significantly, that the ultimate underlying collateral has fixed income cash flows. In either case however, the use of a fund intermediary has the potential to be abused and requires significant judgment to understand the substance and nature of the ultimate underlying risk. This has already been recognized by the establishment of processes for the SVO to provide NAIC Designations for fixed-income-like funds. It would then follow that debt instruments backed by the types of funds that would ordinarily be required to be filed with the SVO, should follow the same process.

Regulatory Guidance - As noted in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual), Part One, Policies of the NAIC Valuation of Securities (E) Task Force, paragraph 112:

> *The "fixed-income-like" regulatory treatment accorded under this Section only applies to funds that the SVO has verified meet eligibility criteria established by the VOS/TF and been assigned NAIC Designations or reviewed under the verification procedures and added to an NAIC List or other NAIC compilation process as hereafter discussed in this section. The use of NAIC CRP credit ratings under the filing exempt process discussed in Part Three of this Manual shall not be an acceptable basis to apply for and receive the regulatory treatment specified in this section.*

Equity and fund investments that are structured through another legal entity have been able to qualify as 'bonds' under the current definition due to their legal form (instead of substance as with the proposed bond definition) and bypass reporting requirements for equity and fund investments. These structures have sometimes been referred to generically as "Rated Notes", but they may be called other names. The name may change but the general framework is the same: an equity or fund investment is transformed into what the insurer reports as a bond through the insertion of an intervening entity, which issues a note that, due to a CRP rating, receives the statutory treatment of a bond for accounting, reporting, RBC and NAIC Designation purposes. This process exploits the inherent weakness within the Filing Exempt process where anything with a CRP rating is assumed to be a "bond" and automatically treated as such despite its underlying assets, structure, or risk. These transactions can also permit the deferral of interest and/or principal payments, sometimes without capitalization and without being an event of default, introducing additional other non-payment risks not reflected in the CRP ratings used in the FE process.

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Example Structures and RBC Impact – The typical structure for these investments starts with a source entity, the Main Fund in *Figure 1*, that holds the underlying assets, which may be fixed income investments, but there can be many variations in the type and nature of the underlying asset. If the Main Fund, managed by General Partners (GP), were to sell Limited Partnership Interests (LP Interest) directly to an insurer, as investor, the LP Interest would typically fall under *SSAP No. 48 – Joint Ventures, Partnerships and Limited Liability Companies* and be reported on Schedule BA. The investment would then receive an equity RBC charge unless filed with the SVO for a NAIC Designation. However, in a structured equity and funds transaction, an investor in the Main Fund is able to circumvent regulatory guidance when the LP Interest is routed through an intermediate private entity, the Debt Feeder Fund in *Figure 1*, which issues one or more tranches of notes and possibly a small equity or limited partnership interest in itself.

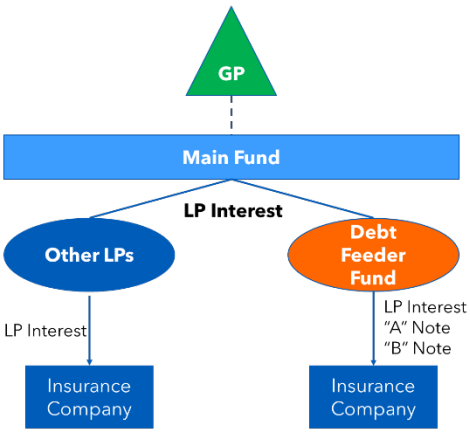

Figure 1

In the PLR filing that alerted the SVO to this type of investment, the assets underlying the structure were purported to be "B" quality fixed income investments. Specific details about the underlying investments were not provided and there was no transparency as to whether they were bonds, mortgage loans, real estate, affiliate notes or some other type of asset. The transaction was described as a Debt Feeder Fund issuing "investment units" comprised of 90% Senior Notes and 10% limited partnership interest, implying that the investor must participate in both, though this joining of the note to equity may not always be required in other structures. The weighted average life of the assets was identified as four-years but the Senior Notes had a remaining term of 12 years and paid interest of 8.00%, which could be deferred without capitalization. The Senior Notes were rated BBB+ by a CRP.

The issuing Debt Feeder Fund sells the "investment units" (a note and LP Interest) to insurers who report the note as a "bond" under *SSAP No. 26R – Bonds* and the small portion of equity as a joint venture or LP Interest under *SSAP No. 48 – Joint Ventures, Partnerships and Limited Liability Companies.* There is no transparency that the notes issued by the Debt Feeder Fund are backed only by a separate LP Interest in the Main Fund. Either directly or indirectly, an investment in a limited partnership interest or equity investment is transformed into a "bond" because of its legal structure, without any review of its substance as a fixed-income instrument, which would be required under the proposed bond definition and is required today in the P&P Manual in order to assign an NAIC Designation to non-registered private funds with underlying assets having characteristics of bonds or preferred stock.

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Continuing this example in *Figure 2,* the Debt Feeder Fund, as issuer, issues $90 million in notes and $10 million in LP interests that are purchased by insurers. The $100 million in total proceeds are used by the Debt Feeder Fund to acquire an LP Interest in the Main Fund. The Main Fund uses proceeds from Debt Feeder Fund's LP Interest investment to invest in what are reported to be "B" rated fixed income securities

By investing in the investment units issued by the Debt Feeder Fund, an insurer is able circumvent regulatory guidance by transforming the Main Fund's investments in "B" rated loans into a much higher rated note due to the intervening legal entity. An insurer investing in the investment unit (note and equity) would be able to dramatically reduce its risk-based capital versus reporting an LP Interest investment in the main fund holding "B" rated loans but be exposed to identical economic risk. Using the information provided in the PLR implies, as noted in *Figure 2*, the insurer making this investment could reduce its risk-based capital by 56.6%, an RBC factor reduction of 5.40%, if it invested in the investment unit (note and equity) with the note rated by a CRP instead of investing in the underlying assets directly while maintaining the exact same economic exposure. If a Health or Property Casualty insurer invested in this structure the risk-based capital arbitrage advantage could be significantly higher because those insurers cannot take advantage of an SVO assigned NAIC Designation for a Schedule BA Non-Registered Private Fund with Underlying Assets Having the Characteristics of Bonds or Preferred Stock in their RBC reporting schedules. If the note's NAIC Designation was not derived from this CRP PLR rating, the risk-based capital arbitrage neutral NAIC Designation Category for the notes would be an NAIC 4.A and the LP Interest would receive an NAIC 6 equivalent treatment. It is worth noting that the difference in this example is similar in concept to the RBC reduction that occurs through a CLO from owning the underlying loans directly.

Rating / NAIC Designation	RBC Factor	Own Directly	Own through Issuing Entity
BBB+ / NAIC 2.A	1.261%		$ 90
…			
B / NAIC 4.B	9.535%	$ 100	
…			
Equity / NAIC 6	30.000%		$ 10
Total Investment		$ 100	$ 100

Resulting RBC	9.535%	4.135%
RBC Arbitrage Opportunity	-5.400%	
% reduction	-56.635%	

Figure 2

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Another example transaction that the SVO received as a PLR filing in which a private equity interest is converted into a "bond" involves a limited liability corporation (LLC) whose sole asset is an equity interest in a commercial real estate investment brokers partnership. The LLC issues two term loans, Term Loan A for $55 million with a CRP rating of BBB- and Term Loan B for $55 million with a CRP rating of BB. The LLC's only source of revenue to make scheduled payments is from distributions on the partnership equity investment but this is not transparent because the investments are reported as bonds. Interest and principal payments on the Term Loans are both permitted to accrue and non-payment does not constitute an event of default. The Term Loans are subordinate to other payment obligations of the LLC including administrative fees. The PLR mentioned that a prior issuance prioritized the payment of the LLC's management fees above payments to investors, which implies it possessed additional risk.

Rating / NAIC Designation	RBC Factor	Own Directly	Own through Issuing Entity
BBB- / NAIC 2.C	2.168%		$ 55
…			
BB / NAIC 3.B	4.537%		$ 55
…			
Equity / NAIC 6	30.000%	$ 110	
Total Investment		$ 110	$ 110

Resulting RBC	30.000%	3.353%
RBC Arbitrage Opportunity	-26.648%	
% reduction	-88.825%	

Figure 3

From this information the SVO estimated in *Figure 3* that an insurer could reduce its risk-based capital by 88.8%, an RBC factor reduction of 26.65%, if they purchased the two Term Loans instead of reporting the equity investment in the partnership. If the notes did not rely upon a CRP rating for assignment of an NAIC Designation, the risk-based capital arbitrage neutral NAIC Designation Category for them would be an NAIC 6 as the underlying investment is equity.

Recommendation – Given the magnitude of these RBC arbitrage opportunities, the judgment involved in assessing the nature of the ultimate risk, the lack of transparency, circumvention of regulatory guidance and the reliance on CRP ratings to accomplish these ends, the SVO proposes amending the P&P Manual to include a definition for Structured Equity and Fund and to exclude such investments from Filing Exemption eligibility. The proposed amendment would not change how the investment is classified for reporting by the insurer but it would ensure that the NAIC Designation and Category assigned are appropriate for the risk and eliminate this version of RBC arbitrage.

Proposed Amendment - The proposed text changes to the P&P Manual are shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2022 P&P Manual format.

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

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NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

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STRUCTURED EQUITY AND FUNDS

Intent

118. Transactions meeting the criteria of Structured Equity and Funds as defined in Part Three of this Manual must be submitted to the SVO for review.

NOTE: See "Structured Equity and Funds" in Part Three for filing instructions, documentation requirements and methodology applicable to Structured Equity and Funds investments.

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

1. The filing exemption procedure does not apply to:

   …

   - **Structured Equity and Funds -** Transactions meeting the criteria of Structured Equity and Funds as specified in this Manual are not eligible for filing exemption and are subject to assessment by SVO.

STRUCTURED EQUITY AND FUND

Definition

320. A Structured Equity and Fund investment is a note issued by, or equity or limited partnership interest in, a special purpose vehicle, trust, limited liability company, limited partnership, or other legal entity type, as issuer, the contractually promised payments of which are wholly dependent, directly or indirectly, upon payments or distributions from one or more underlying equity or fund investments. The inclusion of an intervening legal entity or entities between the Structured Equity and Fund investment issuer and the underlying equity or fund(s), does not change the risk that the insurer investment is ultimately dependent, in whole or in part, upon an investment in equity or one or more funds and its underlying investments. Any design that circumvents this definition, and related examples, through technical means but which in substance achieves the same ends or poses the same risk, shall be deemed a Structured Equity and Fund.

Example Transactions

321. *Example 1* - The Structured Equity and Fund issuing entity issues a note and a small equity or limited partnership interests in itself. The Structured Equity and Fund investment issuer invests the issuance proceeds directly or indirectly in other underlying investments that may or may not be admitted assets or fixed income like. The insurer may invest in the notes or equity, and may be required to invest in both as part of an investment unit. The Structured Equity and Fund issuer in this example is a feeder fund that issues $90 million in notes and $10 million in limited partnership interests and uses the $100 million in total proceeds to invest, either directly or indirectly through a main fund, in "B" rated securities. Insurers purchase investment units comprised of 90% Senior Notes and 10% limited partnership interest. The bonds are described as Senior Notes with and interest of 8.00% but interest payments can be deferred without capitalization. The Senior Notes were rated BBB+ by the CRP.

322. *Example 2* – The Structured Equity and Fund issuing entity is a limited liability corporation (LLC) whose sole asset is an equity interest in a commercial real estate investment brokers partnership. The private equity interest is converted into a bond through an intervening LLC entity that issues two Term Loans, both of which received a NAIC CRP rating. The LLC issues two term loans, Term Loan A for $55 million with a NAIC CRP rating of BBB- and Term Loan B for $55 million with a NAIC CRP rating of BB. The LLC's only source of revenue to make scheduled payments on the Term Loans is from distributions from its equity investment in the partnership. Interest and principal payments on the Term Loans are both permitted to accrue and non-payment does not constitute an event of default. The Term Loans are subordinate to other payment obligations of the LLC including administrative fees and management fees.

REQUIRED DOCUMENTATION AND ANALYTICAL PROCEDURES

Documentation

323. An insurance company investing in a Structured Equity and Fund issuance shall provide information sufficient for the SVO to conduct a look through assessment and credit risk assessment, as described below in this section. The entity issuing the Structured Equity and Fund may also provide this information through a completed RTAS Application sponsored by the insurer (Information about the RTAS process is contained here: www.naic.org/documents/svo_rtas_app.pdf). The following additional information is required for a Structured Equity and Fund:

- Disclosure of any Subsidiary, Controlled or Affiliated relationship, as described in this manual and the *Accounting Practices & Procedures Manual*, between the issuer, any intermediate entity, any of the underlying investments, including the parties from which they were acquired, and the insurer.
- Prior four quarterly financial statements, if produced, and trustee or collateral agent reports from the Structured Equity and Fund issuer 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).
- The legal agreement(s) governing the Structured Equity and Fund structure, the securities it issues, investments it has made and any other agreement potentially impacting payments to investors; including, but not limited to, Prospectus and Statement of Additional Information (SAI), the Private Placement Memorandum, Limited Partnership Agreement or Limited Liability Company Agreement, the Subscription Agreement, the Form D, if one has been filed, and any sale or transfer agreements.
- Schedules of the fund's portfolio securities and assets with a description of the security, the CUSIP or other security identifier and NRSRO credit ratings for the last four quarters of the fund's existence. For funds which use derivative transactions or other derivative instruments, the schedule shall include information for each derivative.

Analytical Procedures

324. Credit Risk Assessment – The SVO may, in accordance with authority granted to it Part One, apply any methodology it deems appropriate to assess the credit risk of a Structured Equity and Fund issuance and its ultimate underlying assets identified pursuant a look-through assessment. Such methodologies include, but are not limited to, a weighted average rating factor (WARF) methodology or a CRP's rating rationale analysis of the issuance, notched as the SVO deems appropriate to eliminate any risk-based capital arbitrage that may exist through this structure.

The NAIC Designation and Category assigned to each security issued by the Structured Equity and Fund issuer may also be adjusted to reflect any credit support within the structure including, but not limited to, subordination, guarantees, insurance, or equity. The objective of the SVO's analysis is to ensure that the overall risk assessment will be risk-based capital neutral when comparing the ultimate underlying assets to the securities issued by the Structured Equity and Fund.

325. Look-through Assessment – A qualitative and quantitative evaluation of all securities and assets underlying a Structured Equity and Fund investment, encompassing the following criteria:

- Verify the type of assets and assess their credit risk, including performing an independent assessment of credit risk, as necessary.
- Assess which assets are consistent with a fixed income like investment and which assets are equity in nature.
- Review each underlying fund for consistency with the NAIC Funds List guidelines provided in this manual. Those which do not meet the guidelines for inclusion on a NAIC Funds List shall be deemed to have a NAIC 6 Designation for purposes of the credit risk assessment.
- Evaluate the extent to which the composition of a Structured Equity and Fund's underlying investment(s) in a fund(s) can vary under normal market conditions given the underlying fund's policies and investment strategies and the extent to which the composition of the underlying fund's portfolio may vary under abnormal market conditions and the extent to which changes in composition of the underlying fund's portfolio in abnormal market conditions may persist given the underlying fund's leverage profile or other relevant factors.

Methodology

326. The SVO shall:

- Conduct a look-through assessment (as explained above in this section).

- Conduct a credit-risk assessment (as explained above in this section) to determine the credit risk of the Structured Equity and Fund's underlying assets and cash flows sufficient to make cash payments to the investors in the securities issued.

Mike Monahan
Senior Director, Accounting Policy
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February 13, 2023

Ms. Carrie Mears, Chair
Valuation of Securities Task Force
National Association of Insurance Commissioners
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Proposed Amendment to Define and Add Guidance for Structured Equity and Funds to the P&P Manual

Dear Ms. Mears,

The undersigned (ACLI, PPIA, and NASVA) appreciate the opportunity to comment on the exposure referred to above that was released for comment by the Valuation of Securities Task Force (VOSTF) on December 14th, 2022.

The Undersigned's Response to the Exposure – In Summary

The exposure has a variety of SVO concerns that are somewhat commingled. Our concerns, some of which are addressed in more detail following, are summarized below.

1. It appears some of the SVO's concerns include:

    a. Pure regulatory arbitrage, when comparing pre-and post-securitization, while holding the same economic risk,
    b. What constitutes a "bond" in concept, specifically for eligibility under SSAP No. 26R and SSAP No. 43R, and
    c. Lack of transparency on the structures and investments held by the underlying fund.

2. Industry is confused by the overlap with other initiatives and exposures, specifically the "Principles-based Bond Definition" initiative, the Risk-Based Capital Investment Risk and Evaluation (E) Working Group (Investment RBC WG) activities, and this Exposure. Projects and other initiatives address those concerns as follows:

    a. The Investment RBC WG agenda currently includes a project to determine the appropriate risk-based capital charge for residual tranches of structured investments, which will address the arbitrage concerns raised in this proposal,

b. SAPWG is currently near finalization of a project to define a bond, including determining eligibility for reporting on Schedule D. The SVO already has an avenue to raise concerns on investments that they do not believe meet the definition of a bond,
c. Private rating letters are now being filed. These letters are quite substantive and should include significant information about fund structures and their largest underlying investments.

3. The exposure name implies that the SVO is focused on feeder funds and structured equity investments. However, concerns associated with potential PIK interest, maturity extensions or other features that are common among securities appear to be commingled within the feeder fund example. To the extent a security has the potential to PIK or defer interest, where such interest is otherwise not capitalized or required to be accrued, or the potential to extend the maturity without paying interest for that extension, the Undersigned agree such a security has non-payment risk. Otherwise, the potential to PIK or defer interest, or the potential to extend the maturity, has real economic or business benefits, often mitigating risk, and should not be in the purview of the SVO for determining NAIC designations that are ultimately used for risk-based capital purposes.

   Presumably, the SVO has concerns related to liquidity risk, but this is not a factor in determining an NAIC designation, nor should it be, and the SVO is not in a position to assess liquidity risk for insurers. The SVO has been focused on securities with the potential to PIK or defer interest, as well as the potential to extend maturity, but we have yet to discern what that concern is other than liquidity risk.

4. The proposed definitional change to the P&P Manual would potentially capture a whole host of more traditional fixed income securities that industry does not believe were intended to be in scope and may be difficult for the SVO to evaluate. The following fixed income securities are explicitly not feeder funds, nor share the same risk profile. Industry notes the following examples potentially captured by the exposure (including but not limited to):

   - Senior secured debt issued by a comingled fund, private or public (SEC 40 Act regulated funds, mutual funds etc.)
   - Senior secured debt issued by SPVs that own or invest in debt instrument(s), whether directly or through tax or jurisdictionally required blockers
   - Senior debt issued by REITs
   - Senior debt issued by BDCs
   - Senior debt issued by entities owning stakes in one active corporate subsidiary, or multiple related active corporate subsidiaries ("holding companies"),
   - Senior debt issued by Collateralized Fund Obligations ("CFOs") through a trust securitization offering
   - Senior debt issued as NAV Loans generally with very low LTVs

   In addition to the cost associated with reviewing these additional transactions, the question arises as to whether the SVO can better assess risk than rating agencies. Some of these structures (such as CFOs) are non-homogenous and require substantial modelling resources to evaluate. Certain rating agencies have developed a niche in assessing these risks. We also note these securities often have significant credit enhancement retained by the issuer that are not

part of the securitization (e.g., CFOs) as well as significant overcollateralization (e.g., NAV Loans, often with LTVs at 10%).

5. The exposure mentions that the SVO could use any methodology that it deems appropriate to designate such funds. There is concern about the lack of transparency of SVO methodologies, and related consistency in designations for similar risk. We believe transparency in methodology, as is happening with CLOs, is important and SVO methodologies should be fully transparent. This would accomplish two objectives – 1) Ensure the SVO is applying methodologies consistently and 2) Provide transparency to the market and industry.

6. A 2021 NAIC Capital Markets Bureau Special Report stated, "On average, designations were 2.375 notches higher, with designations 2.4 notches higher at small CRPs and 1.9 notches higher at large CRPs" than SVO's designations". This statement implies that SVO designations are conservative, even when compared with larger rating agencies. We believe that conservative designations for their own sake should not be the objective of the SVO. Rather, the pursuit of consistent, accurate, and transparent investment risk assessments should be the joint objective of the NAIC, VOSTF, SVO, and Industry. Excess conservatism and lack of transparency for critical processes within the SVO's designation methodology have the potential to create a disconnect between the appropriate risk-based capital charges set by the NAIC's Capital Adequacy's Task Force and SVO designations. Risk-based capital charges are based upon public rating agency experience and is the foundation upon which the capital charges are ultimately based.

   While acknowledging the SVO's designation process generally works well for most traditional corporate bonds that are filed with the SVO, although not without examples of unsubstantiated deviations, the potential for inconsistency in appropriate risk assessment becomes even greater as structural complexity increases. Additionally, having concentrated critical processes under the SVO's sole discretionary purview, including choice of rating methodology to apply, application of that methodology, and the lack of a robust and independent appeals process for industry, does not offer appropriate checks and balances. Currently, industry struggles to understand how the SVO might view securities with new, unusual, or outlier risks and what type of designation the SVO might assign to such securities. The potential for inconsistency in appropriate risk assessment becomes even greater as structural complexity increases. If an SVO designation methodology exists for all asset classes, industry does not understand why they cannot be made both public and transparent. If an SVO designation methodology does not exist for all asset classes, that would be concerning as the SVO looks to expand its role for designating even more complex securities.

   There is also concern that a lack of transparency and applied consistency with the SVO's undisclosed designation methodologies will lead to material capital uncertainties and inconsistent designations. Capital certainty may not officially be a component of an NAIC designation, but we believe all should agree that consistent application of, and transparency of, designation methodology is important to all stakeholders, including the SVO and state regulators. Further, capital certainty and timeliness of designations are very important to insurance companies to manage risk-appetites for risk-based capital in a meaningful way, and to ensure that return on investments covers not only expected losses but also an acceptable return on capital.

7. The undersigned believe the proposed amendment should focus on what we consider should be mutual areas of agreement in principle.

   The SVO should make their methodologies public to help ensure they are applied consistently, the SVO's powers have appropriate checks and balances, and/or they are not overly conservative when compared to rating agencies' ratings and upon which risk-based capital charges are based.

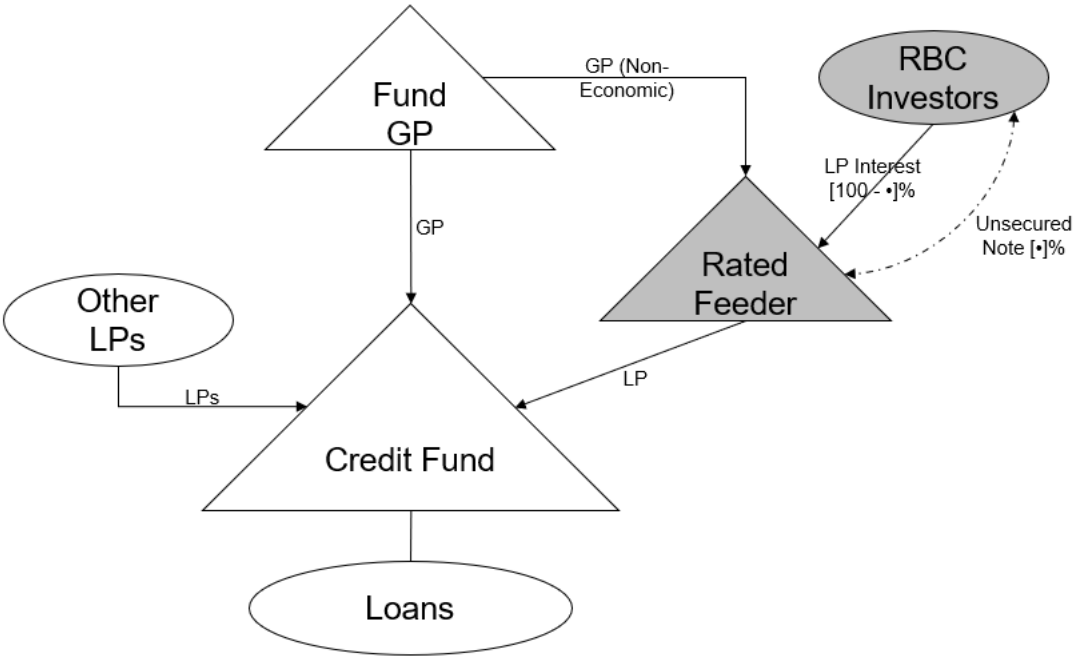
   Even the large rating agencies, who have extensive resources (including sizable staff with dedicated teams for specific asset classes with unique characteristics, trained economists, the latest technology, access to tailored seminars/training for specific asset classes, and access to management), are not experts in all areas.

   As a result, both large and smaller rating agencies have developed particular niche expertise, and no one rating agency rates every type of debt asset class.

The undersigned would like to work together with the SVO and NAIC to better understand their concerns so approaches more tailored toward those specific concerns can be more efficiently addressed. We look forward to having dialogue with you on these issues and stand ready to help.

Feeder Fund Structures

The remaining part of our letter focuses on the feeder fund structure and the examples included within the exposure. A visual depiction of a feeder fund can be shown as follows:



This type of structure, as well as other structures such as CFOs, were subject to significant discussion during the principles-based bond definition project. Early in the project, complex and unworkable rules were being developed in an attempt to address risk-based capital concerns of structures (i.e., allowing for potential risk-based capital arbitrage without a substantial change in economic risk). It was ultimately decided by SAPWG that such concerns were best addressed by revising the definition of a bond in combination with the Investment RBC WG addressing the

appropriate risk-based capital charges for residual tranches. All residual tranches have subsequently moved to Schedule BA and are in scope for potentially higher risk-based capital charges.

During the bond project, industry also shared with regulators that these feeder fund structures provide valuable benefits to the insurance industry, as well for those outside the insurance industry. Feeder funds allow companies to obtain diverse exposure to mezzanine debt (or junior debt, 1st lien debt, etc.) which investors would otherwise not be able do individually due to materiality, individual underwriting expertise, lack of diversification, etc.

The feeder fund structure was initially developed, at least in part, for anti-arbitrage reasons and to allow insurance companies to access funds with a capital charge that puts insurance company investors on a level playing field with pension funds, banks, and other non-insurance investors. The key is that some investors cannot commit sufficiently large capital to do a separately managed account directly, and thus must choose between either foregoing attractive credit risk exposure or taking an overstated risk-based capital charge to access a diversified portfolio of ultimately debt instruments via a fund investment. A pension fund, for example, can invest in the limited partnership directly without similar risk-based capital consequences. But for an insurance company, the risk-based capital charge is 30%. Meanwhile, as noted in the SVO example, the real risk-based capital risk on a look-through basis is lower – in the example only 9.5% – resulting in anti-arbitrage.

The Investment RBC WG agenda currently has a project to determine the appropriate risk-based capital charge for residual tranches commensurate with the levered risk of the residual tranche. An interim solution is anticipated in time for concurrent adoption with the principles-based bond project. In the SVO's example, if the residual tranche risk-based capital charge was set at 65% (i.e., half-way between 30% and 100%) the aggregate risk-based capital charge of owning both the debt and equity tranche would be 7.635% versus 9.535%, essentially eliminating the "arbitrage" as laid out in the feeder fund exposure example. However, the SVO's example only has a 10% equity tranche which is substantially lower than a typical equity tranche. A more representative equity tranche of 25% with a 30% risk-based capital charge would yield an aggregate risk-based capital charge of 8.446% essentially eliminating any arbitrage. A risk-based capital charge of 65% on the residual tranche would yield an aggregate RBC charge of 17.196% which would still be significantly anti-arbitrage.

Further, securities issued by feeder funds are often issued as tranches with associated waterfall structures. These more complicated structures allow apportionment of risk potentially between different entities and/or segments to further allocate risk. Often the investment teams at insurance companies that manage fixed income versus equity portfolios are separate entities. To the extent a debt-oriented fund must be evaluated by an equity portfolio team, the fund will generally not gain traction being a "lower returning opportunity" compared to equity asset classes. This can make the access to this attractive asset class effectively fall through the cracks at many insurance companies. Feeder vehicles can assist these companies to shift the evaluation from their equity portfolio teams to their debt-oriented teams.

Not all feeder fund investors are primarily motivated by risk-based capital treatment; some of them are very focused on having the "reliable and predictable income" that debt tranches from a feeder fund would provide. The complex structuring and apportionment of senior/subordinate risk between tranches is both experience and technology intensive. CRPs have invested materially for years in their capabilities to assess credit risk in these tranched waterfall-based securitizations, and their published methodologies are transparent and consistently applied. We question whether the SVO

could evaluate such structures, for all different types of asset classes, in a more efficient, transparent and/or consistent manner than already performed by the CRPs.

The SVO's WARF methodology can work well where it is currently applied such as when there is direct ownership in an LP interest with no debt, but it becomes problematic when there is debt or when multiple tranches exist with a waterfall structure. Absent this already being addressed by the Investment RBC WG, it might be reasonable to have the SVO apply the WARF methodology and utilize that charge, <u>if</u> the SVO would apply the aggregate 9.535% charge they note is appropriate in the exposure. However, this comes with several practical problems:

1) The SVO exposure suggests any methodology for a designation could be used by the SVO, in their sole discretion without transparency as to considerations given or to ensure consistency of application. A lack of transparency as to methodology has long been a significant challenge industry has raised regarding the SVO, as designations received from the SVO can sometimes seem variable and inconsistent. This can lead to industry uncertainty regarding assessment of risk. While acknowledging the SVO's designation process generally works well with traditional corporate bonds that are filed with the SVO, although not without examples of unsubstantiated deviations, the potential for inconsistency in appropriate risk assessment becomes even greater as structural complexity increases. Trying to gain an understanding of potential outlier risk assessment is generally not achievable with today's SVO structure.

2) The cost of filing such securities with the SVO, which is significant given the proposed scope, could be prohibitively expensive and time consuming given the potential for limited incremental benefits, if any, compared to the status quo. For example, if the underlying debt itself is not rated by a CRP, our understanding is the designation for that underlying bond is automatically deemed a 5B, which is inappropriate, or each individual underlying instruments needs to be filed with an RTAS. The hard cost of filing each security, and each RTAS, combined with the requisite filing requirement for each underlying security (if all such information is even available in the form required), is prohibitive. Rating agencies have devoted significant cost and staff to analyze such securities. For example, industry understands that rating agencies stress each individual CUSIP within the securitization under different scenarios. Many rating agencies also have niche expertise in certain variations of asset backed securities, with different underlying collateral.

3) The SVO's exposure questions both the PIKing or deferral and accruing of interest and circumstances where the weighted average life of the underlying junior debt differs from the term of the note. However, there are valid economic reasons for why these structural features exist, and we think it is an oversimplification to assume that such features are inherently risky.

   For example, while acknowledging significant variations exist (one example cannot cover all contingencies), it is common that the underlying investments in the portfolios of these funds are not typically traded. While the fund manager has the authority to actively manage the fund, in large part the average fund ends up pursuing a "buy and hold" strategy. During the investment period of the underlying fund, investments are originated and purchased by the fund. After the end of the investment period, the fund goes into a "run-off" mode and no further investments are purchased by the fund. As cash is generated from the underlying investments in the fund is distributed to investors in the fund on a pro-rata basis per their respective commitment to the fund. To the extent the investor has come into the fund via a feeder vehicle, then the waterfall provisions of that vehicle will dictate how the cash is distributed to the tranches of securities

that were issued by the feeder vehicle. The portfolio manager has no discretion to redirect these cash flows, and again they are contractually directed per the waterfall.

Generally speaking, feeder vehicles are structured such that once an underlying fund portfolio has "ramped-up", given the inherent overcollateralization of these structures from the viewpoint of the rated notes, ample cash flow is generated from the fund's assets to pay the contractual cash coupons on the rated notes issued by the feeder vehicle. After paying administrative expenses, all cash received during each period is first available to pay the interest due on the Senior Notes of the feeder vehicle, followed by interest due on any Subordinated Note tranches. During the investment period, it is typical that any remaining cash be distributed to the residual or equity tranche of the feeder vehicle, while after the investment period this cash would otherwise be used to pay down principal of the Senior Notes (until fully repaid) and then any Subordinated Notes, prior to being applied to the residual tranche.

Given the structure of a typical feeder vehicle and the waterfall priorities, it is highly unlikely that interest due to the Senior Notes issued by a vehicle would not be paid in cash. For any Subordinated Notes, to the extent there is not sufficient cash flow received on a current basis in a particular period of time to pay the interest due on those notes, then that interest is PIKed or otherwise accrued for the current period. Per the priority structure of the waterfall, that interest will then have to be paid in cash from cash received from the underlying fund investments in subsequent periods. This amount due will remain outstanding and retain its priority in the waterfall until fully repaid.

For an underlying fund that primarily holds private debt investments in its portfolio, these investments may typically have legal maturities of 7-10 years. Given that these investments can generally be prepaid by their issuing companies several years before the legal final maturities, and with the normal life cycle of private equity ownerships of companies generally, it is very common that these investments will only be held by the underlying fund for ~3-4 years.

With a typical structure for a feeder vehicle, the note tranches issued by the vehicle will generally have debt maturities longer than the maturities of the investments in the underlying fund (and practically speaking much longer than the actual hold period for most investments in those funds). Since all cash received from the underlying investments is directed by the feeder vehicle waterfall structure to pay down interest and then principal of the notes issued by the feeder vehicle, this potential mismatch is not problematic. In fact, this is a credit enhancement for the notes issued by the feeder vehicle that ensures there is no need for distributions in kind.

As noted in our previous letter on Subscript S and non-payment risk, there are valid reasons for potential PIK interest (or deferral of interest) as well as for potential maturity extension features, and if structured appropriately, they do not represent non-payment risk. A US Treasury security can be a PIK security, for example. The SVO's exposure says the interest "could" be deferred without capitalization. It is unclear in the example cited, whether this is the case or "could" is used more generally. However, if the debt interest can be deferred without capitalization or otherwise being accrued, as stated in the deal documents, we agree that is non-payment risk and have no disagreement that it should be filed with the SVO as a non-filing exempt security. Although we are generally not aware of such securities being utilized, we agree that, to extent such securities exist, we are comfortable filing them. However, we do not think the presence of a PIK interest feature that capitalizes interest when used, is problematic.

4) The exposure's second example doesn't appear to have an equity tranche, and therefore the analysis presented in the exposure would not be practically appropriate. In any instance, we do not believe the math is correct in the SVO's analysis. To arrive at the SVOs risk-based capital charges, both debt tranches would have to be 50 and 50, not 55 and 55. The "BB Debt" would not be debt and would have an equity charge of 30% resulting in an aggregate RBC charge of 17.6925% in this instance. Should it be 65% the aggregate risk-based capital charge would be 37%. That is greater than the risk-based capital charge of the underlying equity.

Industry believes that feeder fund structures should be left, as originally planned by SAPWG, to be addressed by the Investment RBC WG. Additionally, industry does not deem the presence of PIK interest and principal extension features in securities to automatically translate to higher risks that would necessitate a filing with the SVO. The SVO was recently granted the authority to review private rating letter rationales (which are in-depth reports) and report suspected non-bonds to regulators, and regulators can react accordingly. It is unnecessary to make a large swath of any given asset class non-filing exempt in order to identify instances of potential abuse.

*****

We stand ready to work collaboratively with the Task Force and SVO on this and other matters in the future

Sincerely,

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey
Tracey Lindsey
NASVA

John Petchler
John Petchler
on behalf of PPiA
Board of Director

PineBridge® INVESTMENTS

February 13, 2023

Dear Mr. Therriault, Ms. Mears, and VOSTF members:

We greatly appreciate the opportunity to comment on your proposal on structured equity and funds. We support your mission of promoting transparency and enhancing risk assessment for statutory solvency purposes. We believe that not all structures create statutory "capital arbitrage" nor are intended to do so. In fact, the intent of many of these vehicles is to create a more operationally efficient way for insurers to access certain asset classes, with the added goal of doing so in a manner that results in similar capital treatment to that of the underlying assets. One unintended consequence in our view is that lack of these structures could make smaller insurers less competitive, as they are forced to hold assets directly on balance sheet via separate accounts. Most times only larger insurers have the scale and operational infrastructure required to do so. The rationale is akin to insurers investing in ETFs, and the NAIC's ETF designation accomplished a sensible positive change for smaller insurers.

We recognize that insurers can submit funds for SVO designations, but unfortunately those designations only provide RBC relief for life insurers. Although not the focus of this comment letter, we believe that lack of fund RBC benefit for non-life insurers has a knock-on impact on the utility and value of feeder notes. An adjacent issue is Schedule BA limits. Once again, we find smaller insurers are at a competitive disadvantage for investing in fixed income assets, i.e., they are filed on Schedule D Part 1 as bonds if held directly, but they must be filed on Schedule BA if held in a fund format. And these structures can help close that disadvantage somewhat, though usually not entirely.

We fully agree with the NAIC's focus on substance over form and that capital charges should reflect the underlying risk exposure. This should mean focusing truly on the substance of the investment, and if there is a fund vehicle in the structure, the assets within that fund. A fund is merely a wrapper and is not indicative of the investment risk taken, a conclusion the NAIC similarly reached on ETFs. We recognize that there could be abuses of feeder notes and related structures, whether to accomplish capital arbitrage or to wrap assets that would otherwise be non-admitted. We believe these cases are the minority, and therefore it would be more sensible to create a framework that captures likely abuses, as opposed to making thousands of securities no longer Filing Exempt (FE). The latter seems like an extreme action that would be impractical and difficult to implement. It seems unreasonable and unpractical to ask the NAIC to re-assess the designation of thousands of securities, especially considering the resources required. In addition, the NAIC would likely need to establish a variety of new methodologies and detailed public disclosures, whereas existing NRSROs have invested heavily in people and methodologies to analyze private and structured assets properly. A much better solution, in our view, would be to create a practical framework that could help root out abuses. We would recommend utilizing the set of red flags already developed by the SVO and SSG back in 2019,[1] specifically:

1. Rating from a single rating agency
2. Private letter rating
3. Assets backing the security were primarily owned by insurer or affiliates before that transaction and reported differently
4. Assets backing the security may not generate bond cash flows (i.e., contractual requirements to pay periodic principal and interests) or they are equity securities
5. The insurer or affiliated group are the sole investors in security
6. The affiliate of company is underwriter or sponsor of the security

[1] NAIC Valuation of Securities Taskforce, 10 May 2019, Meeting Minutes.

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A practical approach might be by utilizing the above red flags, one can create a framework to better bucket the respective investments and take appropriate actions. The mechanism could be simply based on the number of red flags, a combination of the flags, or a more quantitative scoring system. Tripping a single flag on its own may not necessarily be problematic, but some combinations thereof may warrant review by the SVO. We would like to work with the industry and the respective working groups to align on what falls into each respective bucket and subsequent actions to be taken if any. The bucketing framework could be along the lines of:

- **Unlikely abuse**: security remains FE eligible and maps to the CRP rating
- **Potential abuse**: security requires SVO validation to utilize the CRP rating for FE purposes. This may mean a quick review by the SVO, e.g., if they are rated debt securities, applying the WARF methodology to validate the reasonableness of the CRP rating
- **Likely abuse**: security must be submitted to the SVO for a full review, and the SVO may adjust the NAIC designation, statutory filing schedule, or status as admitted/non-admitted

Another critical aspect of all this is transparency. The NAIC and state regulators have made it clear how important it is for insurers to provide greater transparency about their investments, and likewise we believe the industry deserves transparency from the NAIC on these potential regulatory changes. Most notably, these processes and any potential changes to investment RBC must be clear, with much greater detail on how the SVO and SSG would capture potential abuses and potential RBC or accounting adjustments. If changes were to be made as reflected currently in the structured equity and funds proposal, we fear it creates an unreasonable and challenging dynamic for insurers, since they may be forced to make investment decisions with considerable uncertainty around statutory capital. We hope you would agree that a more practical solution that could mitigate that uncertainty yet also remove abuses is one that best meets the needs of both the industry and regulators.

Sincerely yours,
PineBridge Insurance Solutions and Strategies

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February 10, 2023

Doug Ommen, Chair
Valuation of Securities (E) Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Dear Commissioner Ommen:

Varagon Capital Partners ("Varagon", "we" or "us") appreciates the opportunity to comment on the proposed amendments to the Purposes and Procedures Manual of the NAIC Investment Analysis Office ("P&P") regarding Structured Equity and Funds. These amendments were exposed as part of the November 28, 2022 memorandum (the "SVO Memorandum") from Charles A. Therriault and Marc Perlman of the Securities Valuation Office ("SVO") to the Valuation of Securities (E) Task Force ("VOSTF"). As background, Varagon has worked closely with insurers since the firm's 2014 inception, investing on their behalf in performing middle market loans through both on balance sheet separate accounts and rated vehicles.

We write in opposition to the proposal to amend the P&P to make Structured Equity and Fund investments ineligible for the automatic filing exemption in instances where the underlying investment assets substantially comprise debt instruments. These investments serve a valuable role in insurance company balance sheet management and capitalization, and requiring an SVO filing in each instance would materially and adversely affect the markets in these instruments. As an initial matter, we wish to specify that our analysis in this letter addresses investment structures in which the relevant investment partnership is a private credit fund and where the underlying investment assets comprise business loans and other debt securities.

We wish to point out that the structured treatment and issuance via a special-purpose entity (a "Rated Note Feeder") of multiple tranches of notes, including notes with a private credit rating ("Rated Notes") offer important benefits to the insurance industry, particularly to smaller insurers. Some insurance company investors may not have the operational and administrative resources needed to manage loans (which could number in the hundreds to achieve prudent levels of diversification) held directly on balance sheet. Owning debt instruments via an investment in the partnership interests of an investment fund partnership entity (a "Fund") essentially converts debt to equity treatment, making the investment uneconomic from a regulatory capital perspective as the debt portfolio does not generate returns commensurate with equity funds. Holding the Rated Notes based on underlying debt instruments provides those insurers with exposure to the underlying loan assets while maintaining capital treatment generally consistent with a portfolio of the same loans held directly on balance sheet. The Rated Notes are also more operationally

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efficient as compared to holding these debt instruments on balance sheet, which is especially important as they enable smaller insurers to gain exposure to these assets in a turn-key format.

As companies carrying a large amount of investable capital, coupled with a landscape of upcoming long-term liabilities that will need to be met, it is crucial for insurance companies to have opportunities to generate investment returns in a capital-efficient manner. For smaller insurance companies that have access to fewer investment opportunities, opportunities to invest through Rated Note Feeders are valuable to maintaining long-term financial health and the solvency to meet their coverage obligations.

Moreover, by separating levels of risk, the Rated Note Feeder structure allows insurance companies the opportunity to earn favorable returns at a lower risk than would otherwise be possible, and at the precise cost level that matches the risk undertaken. In this context, quantifying the risk-reward tradeoff is a helpful tool. Insurance companies may achieve an optimal risk-return by offloading the riskier equity tranche, to the extent preferable. In cases where an insurance company retains the equity tranche of a Rated Note Feeder, as noted above, the blended capital treatment across the Rated Note Feeder is typically the same as or similar to the capital treatment associated with holding the loans directly on balance sheet.

Contrary to the SVO Memorandum, these investments **do not circumvent regulatory guidance or constitute an arbitrage opportunity**. As we note above, it is not the case that Rated Notes issued by Rated Note Feeders are simply a way to re-label an investment in a Fund. The issuance of Rated Notes by a Rated Note Feeder instead segregates the risk of the underlying asset pool into different levels of risk, with the result that investors may invest in some tranches that have risk lower than that of the asset pool as a whole, while other tranches have a higher level of risk than that of the asset pool as a whole. The investors that have invested directly in a Fund are exposed to an average risk level characterized by the entire pool, whereas the risk level for investors in the Rated Notes issued by a Rated Note Feeder can be categorized based on the ratings of each tranche held by such investors. This is demonstrated by the fact that the rating agencies can grant a rating to the senior tranches after analyzing their probability of repayment in full of principal and interest, which probability is judged to be investment-grade in the case of the highest-ranked Rated Notes.

The SVO Memorandum suggests that the equity tranche in an issuance by a Rated Note Feeder is typically in the range of ten percent (10%). The argument appears to be that such a small portion of the issuance being attributed to equity implies an underestimate of risk in the pool as a whole. However, as concerns the Rated Note Feeders we encounter, substantially all of the underlying assets of which comprise loans and other debt securities, we typically see equity tranches (which, for purposes of this letter, refer to those tranches that are not rated by any rating agency) account for at least twenty percent (20%) of the issuance, and sometimes as much as forty to fifty percent (40-50%). In all cases, the percentage of equity in the capital structure of a Rated Note Feeder

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would need to be robust enough to provide the credit enhancement necessary for the Rated Notes to achieve the ratings ascribed to them by a rating agency. Consequently, contrary to the SVO Memorandum, we believe issuances by Rated Note Feeders adequately capture the risk of loss contained in the underlying pool.

Deferral of interest has been cited by NAIC staff as a factor necessitating the removal of the filing exemption. However, deferral of interest does not represent non-payment risk as is found in an equity security. This is true even where principal does not accrete by the amount of deferred interest (so-called "PIK" interest or "Deferred Interest"). The use of PIK or Deferred Interest in Rated Note Feeder structures should be understood as a mechanism for managing the timing of distributable returns during the initial phase (the so-called "Ramp-Up") of the life of the Fund in which the Rated Note Feeder holds an investment. Because the Rated Notes are funded over time (typically a period called the "Investment Period" or "Reinvestment Period"), there will be a Ramp-Up during which, because assets are still in the process of being acquired, income is not yet being generated at the maximum anticipated level. The Deferred Interest feature thus ensures that the Rated Note Feeder need not choose, to investors' detriment, to liquidate assets too early (resulting in a reduction in expected return) in order to avoid a default during the Ramp-Up. We note that many other types of debt investments include deferred interest, including other structured finance products customarily treated as debt (such as some corporate bonds). In addition, some fixed-income instruments, including certain corporate debt, comprise PIK loans and are treated and understood as debt on that basis.

We would also like to take this opportunity to explain why Rated Note Feeders and their issuance of notes, including Rated Notes, are **structured and tranched** the way they are, and why these features do not signify that equity positions are being wrongfully packaged into nominally debt securities. Tranching of the notes issued by the Rated Note Feeder is what makes it possible to reduce the risk to which senior noteholders are exposed. While investors directly investing in a Fund are exposed to the average level of risk in the asset pool as a whole, the issuance by a Rated Note Feeder of different tranches of debt backed by these underlying cash flows enables the senior noteholders to be granted priority of payment, thereby decreasing their risk. While the riskier tranche cannot be rated, the senior tranches can (and thus are Rated Notes) because, as supported by the modeling and analysis performed by the rating agencies, these senior tranches expose the holder to risk commensurate with established rating agency methodologies.

The SVO Memorandum seems to assume that the Rated Notes issued by the Rated Note Feeder lack the characteristics customarily associated with debt instruments. However, it should be noted that most of the specific characteristics listed in the SVO Memorandum as traits of debt instruments are in fact attributable to these Rated Notes. The ultimate underlying investment for the Rated Notes is a pool of fixed-income instruments, namely the loans held in the Fund's asset pool, which generate periodic interest payments. As such, the Rated Notes are serviced by

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predictable cash flows generated by those loans. Moreover, in each accrual period, the underlying pool can be expected to generate an approximately fixed, predictable amount of net income to service the interest rate on the Rated Notes. Finally, we note that the Rated Notes benefit from significant credit enhancement as a result of such structuring.

We note also the Statutory Accounting Principles Working Group's ("SAPWG") ongoing project involving a principles-based bond definition. The SAPWG workstream is already considering many of the same variables and criteria as are suggested by the SVO Memorandum, such as credit enhancement, remedies and tranching. We believe that when considered in light of the SAPWG workstream, Structured Equity and Funds meet all of the relevant criteria to constitute debt securities within the meaning of the applicable statutory accounting guidance. For VOSTF to deprive them of the automatic filing exemption would frustrate this classification and work at cross-purposes with the SAPWG's efforts. We encourage VOSTF to work with SAPWG to avoid regulatory duplication and inconsistency and to harmonize efforts in this area.

Please do not hesitate to contact the undersigned with any comments or questions on the foregoing.

Very truly yours,

Walter J. Owens
Chief Executive Officer, Varagon Capital Partners

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SVO

NAIC
NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Carrie Mears, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau
Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

RE: Operations and goals of the CLO ad-hoc group

DATE: March 6, 2023

Summary: Based on interested party responses to the methodology exposure, staff proposed to rearrange the process of the Ad-hoc group. Specifically, the ad-hoc group will first work on the prepay/discount dynamic to demonstrate the quantitative impact of these proposals on tranche losses. This will also allow interested parties to "tie-out" the model, a task we originally slated for further on in the process. Furthermore, this change will also be responsive to those interested parties who commented that it is difficult to give adequate feedback on a methodology without seeing a suite of assumptions.

Short Term Goals for Ad-Hoc Group

The main goal for the ad-hoc group will be to demonstrate the effects of pre-pay/discount purchase to regulators. This process should take about 2 months, at the conclusion of which staff (and interested parties) will report back to VOSTF.

Secondarily, the ad-hoc group will endeavor to tie out the cash flows on some "dummy" scenarios to ensure the methodology is adequately specified in our documents. Additionally, this arrangement will give time of some interested parties to propose scenarios (as requested).

Operationally, this work will involve 3-4 proxy CLOs deals from industry which will be run through Stress Scenarios A, B and C. Please note that staff is not suggesting that these scenarios will be a part of the final suite of scenarios – they are the easiest to use as they are already specified and exposed.

Interested parties may suggest the proxy deals or staff can select those with high exposure among insurers. We can model the prepayment /discount scenarios proposed by ACLI as well as the no prepay / no discount NAIC assumption. The work will also involve discussion of the need for modeling offsets for prepays/discount.

The dynamic of prepay @ par and purchase below par involves trade-offs. For example. in normal (below 85th percentile) scenarios, companies voluntarily prepay loans due to favorable spread compression. Currently, loan repayments are at their lows because credit spreads have been widening. In these cases, a loan purchased at a discount would imply credit stress or more like a below market credit spread. Should the model assume a spread haircut based on the level of the discount?

Conversely, in periods of credit stress mandatory prepayments will dominate. A discount purchase in these scenarios could imply bargain hunting or the purchase of a stressed credit (the CBO scenario). Should the model assume extra default stress for these scenarios based on the level of the discount?

Ad hoc group operations

The purpose of the ad-hoc group is to resolve and clarify technical and modeling issues. Regulatory policy discussions will be limited and brought back to VOSTF. To ensure that our time is spent productively, staff requests that parties group themselves by interest and only one participant from the group speak at a given meeting. The representatives may change as the topics change.

Otherwise, we hope to keep the meetings open and other parties may submit their concerns in writing to NAIC. If a party believes that its technical are not being actually represented by one of the speaking groups, they should immediately reach out to Eric Kolchinsky (ekolchinsky@naic.org) to resolve the issue.

Staff suggests that non-regulator participants have a technical background for discussion. For example: actuarial, credit modeling or CLOs. CLO participants would ideally have a background in running software, tying out numbers and rating agency methodologies.

Intermediate goals

Staff hopes that at the end of this process, interested parties will have a better understanding of NAIC approach to modeling CLOs as well as have completed the tie out of the bulk of the methodology on "dummy" scenarios. Furthermore, the RBCIRE group will be further along in working on an interim solution for CLO equity and other highly leveraged structures.

The next step would be the proposal of scenarios and the fine-tuning of the probabilities for such scenarios. Staff does not anticipate that any of the above will change the timeline for implementation of CLO modeling.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-03-23 Spring NM/03-CLO Modeling Methodologies/2022TFMemo Ad-hoc 3.5.23.docx

SVO

NAIC
NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

The National Association of Insurance Commissioners (NAIC) is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators of the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, NAIC Members, in their capacity as state insurance regulators, establish standards and best practices, conduct peer review, and coordinate regulatory oversight. NAIC staff supports these efforts, representing the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S. The NAIC is not itself a regulatory entity.

Committees composed of NAIC members conduct the work of the Association. The NAIC has determined that credit quality of insurance company investments provide a sound empirical anchor for certain regulatory functions related to financial solvency regulation. The Valuation of Securities (E) Task Force (VOS/TF) reports to the Financial Condition (E) Committee and formulates and implements NAIC's credit assessment and related policies. The Securities Valuation Office (SVO) are the professional staff assigned to support the VOS/TF. The SVO conducts credit quality assessments of securities owned by state-regulated insurance companies and performs such other duties specified by VOS/TF in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) or assigned by other NAIC regulator groups, from time to time.

The P&P Manual collects the cumulative policies of the VOS/TF, identifies the procedures and methodologies adopted by the VOS/TF for credit assessment of insurer-owned investment securities and provides information on the operational and administrative procedures conducted by the NAIC, the SVO and the Structured Securities Group (SSG) to support the VOS/TF. The P&P Manual is authoritative on these topics over other NAIC publications. The P&P Manual describes the NAIC's use of credit ratings of rating organizations that have been designated a Nationally Recognized Statistical Rating Organization (NRSRO) by the U.S. Securities and Exchange Commission (SEC). The core policies covering the use of credit ratings are in P&P Manual, Part One, paragraphs 58-62, and Part Two, paragraphs 155-163 which is listed below along with a link to the full manual that contains additional references and instructions beyond these core policies related to the use of credit ratings.

To better support the credit assessment processes dependent upon credit ratings, the VOST/TF has compiled the following series of questions that it requests you to respond to in writing and submit back the SVO staff within 30-days. After your responses have been received, the SVO staff will follow up with you to schedule a private meeting with the VOS/TF members and NAIC staff to discuss your comments and answer any additional questions from the VOS/TF members, NAIC staff or yourselves.

Thank you in advance for responding to our questions.

DRAFT

Questions for Credit Rating Providers (CRP) to the NAIC:

1. Please describe what you think the role of credit ratings is now and should be in the future as it related to insurer financial solvency regulation.
2. Please describe what you think would constitute a violation of or exception to the laws and rules governing nationally recognized statistical rating organizations (NRSROs) for each severity level below, according to the U.S. Securities and Exchange Commission's (SEC) Office of Credit Ratings (OCR) or Division of Enforcement: .
    - Minor
    - Serious
    - Severe or egregious
    - Immediate NRSRO status terminated
3. Are you permitted by the SEC's OCR to disclose its finding to the NAIC?
4. Has your firm been given a warning or violation by the SEC's OCR or Division of Enforcement in the past 10-years? If so, please describe each situation, any penalties and remediation.
5. Please describe how you think the NAIC should evaluate the predictiveness of credit rating provider ratings given the NAIC's objective of measuring statistical tail-risk. Tail risk being defined as the probability that the asset performs far below its average past performance, typically in excess of two standard deviations (96th percentile for traditional bonds from an operating entity or conditional tail expectation at the 98th percentile for any type of structured security).
6. Please describe how your ratings align to the NAIC's objective of measuring statistical tail-risk as defined above.
7. Do you consider the impact your rating will have on the regulatory capital of an insurance company that invests in that security?
8. Describe your governance policies and how you ensure independence to avoid conflicts of interest?
9. Please describe your governance and oversight practices. Are they consistent for every asset class and type of rating? If not, explain the differences.
10. Which committees, persons or entities can challenge an analyst rating and who is involved in this process? What level is this in the organization and is this a formal process?
11. How many clients do you have whose fees exceed 1% of your total revenues? Please list those clients with fees in excess of 1% of revenues and the fees paid.
12. Under what circumstances or situations would you decline to rate a security?
13. Under what circumstances or situations would you withdraw a security's rating?
14. Describe if and how you use market data (e.g. credit default swaps pricing, bond market yield spread to USTs or some other observable metric) to validate ratings.
15. Describe the differences between your solicited and unsolicited ratings.

16. What is the percentage of your ratings are point in time versus continuously monitored?
17. Please describe the differences between your public and privately issued ratings.
18. What is your percentage distribution of ratings by assets class and security type (as described in your methodologies)?
    - Public vs. privately issued
    - Solicited vs. unsolicited
    - Withdrawn
19. How do you report withdrawn ratings on your Form NRSRO transitions and cumulative default statistics?
20. What would cause you to change a methodology? And how is the credit committee involved with setting methodologies?
21. Do you have the ability to provide detailed ratings transition history over longer periods of time (e.g. 25-years)?
22. Do you have idealized expected loss given default percentages for each rating? Does it differ across methodology or asset class? Over what time period at they calculated? Do you publish them and/or publish a comparison of actual experience to them?

PURPOSES AND PROCEDURES MANUAL OF THE NAIC INVESTMENT ANALYSIS OFFICE (P&P MANUAL)

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

THE USE OF CREDIT RATINGS OF NRSROS IN NAIC PROCESSES

NOTE: See "Policies Applicable to the Filing Exemption (FE) Process" below; "NAIC Policy on the Use of Credit Ratings of NRSROs" (especially "Definition – Credit Ratings Eligible for Translation to NAIC Designations") in Part Two (the definition of "Eligible NAIC CRP Credit Ratings" excludes the use of any credit rating assigned to a security type *where the NAIC has determined that the security type is not eligible to be reported on Schedule D or that it is not appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of the security or asset*); and "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three.

Providing Credit Rating Services to the NAIC

58. The NAIC uses credit ratings for a number of regulatory purposes, including, to administer the filing exempt rule. Any rating organization that has been designated a Nationally Recognized Statistical Rating Organization (NRSRO) by the U.S. Securities and Exchange Commission (SEC) and which continues to be subject to federal regulation, may apply to provide Credit Rating Services[1] to the NAIC.

Policy and Legal Disclosure Pertaining to the NAIC Credit Rating Provider (CRP) List

59. The NAIC uses publicly available credit ratings, when available, as one component of the services it provides to state insurance regulators concerned with financial solvency monitoring of insurance company investments.

60. In adopting or in implementing the procedure described in this section, the NAIC acts solely as a private consumer of publicly available credit ratings. The sole NAIC objective in obtaining and using publicly available credit ratings is to conserve limited regulatory resources; e.g., the resources of the SVO. The VOS/TF has established the procedure specified in this section solely to ensure that the NAIC can avail itself of publicly available credit rating opinions.

[1] **Credit Rating Services** is defined as: (a) electronic data feed transmissions of credit ratings assigned by the NRSRO with their corresponding CUSIP number and other pertinent security specific information in English, updated as frequently as provided to other customers; (b) other analytical services or products, in English, provided to other customers; and (c) access to the NRSRO's rating analysts by SVO staff.

No Waiver/Express Reservation of Authority

61. Nothing in this section should be interpreted or construed as a waiver of the authority of the VOS/TF, in its sole and absolute discretion, to modify or change, in any manner whatsoever, the NAIC Policy on the Use of Credit Ratings of NRSROs, including but not limited to:

    - Directing the removal of one or more NRSROs from the NAIC Credit Rating Provider List (subject only to the adjustment of any existing contractual obligations);
    - Directing the SVO to study any issue related to NRSRO operations in furtherance of state insurance regulatory policy;
    - eliminating the NAIC Credit Rating Provider List; or
    - Directing any other action or activity the VOS/TF may deem to be useful or necessary to the creation, maintenance or discharge of state-based regulatory policy.

62. The NAIC is not selecting, approving or certifying NRSROs or other rating organizations or distinguishing among them for any public or policy purpose whatsoever. Nor is the NAIC endorsing the credit rating or analytical product of any CRP or rating organization or distinguishing between CRPs or rating organizations for any specific public purpose. The NAIC disclaims any authority to regulate CRPs or rating organizations.

PART TWO: OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

NAIC POLICY ON THE USE OF CREDIT RATINGS OF NRSROS

NOTE: See "Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force, "Use of Credit Ratings of NRSROs in NAIC Processes" and "Policies Applicable to the Filing Exemption (FE) Process" in Part One; "Definition – Credit Ratings Eligible for Translation to NAIC Designations in this "NAIC Policy on the Use of Credit Ratings of NRSROs"; "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three; and "Filing Exemption Status of RMBS and CMBS" in Part Four, which excludes RMBS and CMBS from the use of NRRO credit ratings for NAIC regulatory processes.

Procedure to Become an NAIC Credit Rating Provider

155. An NRSRO that wishes to provide Credit Rating Services to the NAIC may indicate its interest by sending a letter to the Chair of the VOS/TF with a copy to the Director of the SVO, in which it:

- Indicates an interest in providing Credit Rating Services to the NAIC.
- Confirms that it is currently an NRSRO subject to regulation by the SEC.
- Provides a chart relating its credit rating symbols to NAIC Designations.
- Indicates that the NRSRO agrees to enter into a legally binding agreement under which the NRSRO will:
  - Provide Credit Rating Services to the NAIC at no cost;
  - Reimburse the NAIC for all costs associated with: integration of its data feed into NAIC systems, subsequent changes to NAIC systems to accommodate changes in the NRSRO's systems and changes to NAIC systems as a result of the termination of Credit Rating Services by the NRSRO;
  - Give written notice 6 months prior to terminating Credit Rating Services; and
  - Agree not to claim in marketing literature that the provision of Credit Rating Services indicates NAIC approval or endorsement of the NRSRO, its products or services.

156. Adding the NRSRO to the NAIC Credit Rating Provider List When directed to do so by the VOS/TF, the SVO shall add the name of the NRSRO (hereafter described as a Credit Rating Provider (CRP)) to the NAIC Credit Rating Provider List in the publication of this Manual that follows the execution of an agreement between the NAIC and the NRSRO.

Regulatory Significance – Filing Exempt Rule

157. Adding the name of an NRSRO to the Credit Rating Provider List indicates that insurance companies must use the credit ratings assigned by that NRSRO, if any, when determining the NAIC Designation equivalent for a security to be reported under the filing exempt rule. Only those NAIC CRP ratings that meet the definition below may be translated into NAIC Designations under the filing exempt rule. Securities assigned ratings by NAIC CRPs that do not meet the definition below, shall be filed with the SVO. The translation of a NAIC CRP rating into an NAIC Designation is conducted in accordance with the procedures described in this Manual.

Definition – Credit Ratings Eligible for Translation to NAIC Designations

158. As disclosed below, the NAIC may determine that the rated security or investment is of a type that is not eligible to be reported on Schedule D or that the NAIC determines is not appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of a specific asset class, as specified in this manual.

159. The credit rating of the CRP to which this section and the NAIC Credit Rating Provider List refers is the (a) credit rating assigned by the NAIC CRP; (b) by application of its long-term obligation ratings scale and methodology; to (c) securities.

160. Credit ratings of a NAIC CRP that meet this definition are entitled to a presumption of convertibility to the equivalent NAIC Designation published in the NAIC Credit Rating Provider List except that the presumption of convertibility is subject to the following limitations:

- Those rating activities or markets in which the entity has NAIC CRP status.
- Securities with monitored NAIC CRP ratings that:
  - Are monitored at least annually by the CRP that issued the rating;
  - Are assigned to a specific issue that must be specifically identified;
  - Apply to securities where the issuer promises to repay principal and interest or dividends;
  - Convey an opinion as to the likelihood of payment of both principal and interest/dividends due from the issuer to the holders of the security; or
  - Are structured to pay only principal or only interest/dividends, if the monitored NAIC CRP rating addresses the likelihood of payment of either the principal, in the case of a security structured to pay only principal or the interest/dividends, in the case of security structured to pay only interest/dividends (an "Eligible NAIC CRP Rating").

161. The NAIC may determine that the rated security or investment is of a type that is not eligible to be reported on Schedule D or that the NAIC determines is not appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of a specific asset class, as specified in this manual.

Special Rating Systems

162. Unless otherwise specifically approved by the VOS/TF special rating systems of any CRP, rating agency or rating organization shall not be entitled to a presumption of convertibility. Nevertheless, an SVO analyst assessing a security that has been assigned such a rating by any rating organization, including a CRP, may consider the information imparted by that rating or a related research report as one factor in determining an NAIC Designation.

Disclosures and Considerations Related to the Translation of Credit Ratings into NAIC Designations

163. The presumption of convertibility accorded to a credit rating of a NAIC CRP should not be interpreted to indicate that NAIC Designations and NAIC CRP credit ratings are produced using identical methodologies or that they are intended to communicate the same information. SVO credit assessment is conducted for regulatory purposes and may therefore include considerations or address concerns unique to the regulatory community.

SVO

NAIC
NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Carrie Mears, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

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

RE: Proposed Amendment to update Notice of Credit Deterioration for the List of Qualified U.S. Financial Institutions in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "Purposes and Procedures Manual")

DATE: March 13, 2023

Summary – The SVO maintains the List of Qualified U.S. Financial Institutions ("QUSFI") which indicates the financial institutions eligible to issue letters of credit ("LOCs") which, pursuant to Section 3 of the Credit for Reinsurance Model Law ("Model #785"), can be used to reduce an insurers liability when ceding reinsurance to certain assuming insurers. To qualify as a QUSFI the LOC issuing financial institution needs to meet the criteria listed in Section 4 of Model #785, which includes a requirement that the financial institution "*Has been determined by either the commissioner or the Securities Valuation Office of the National Association of Insurance Commissioners to meet such standards of financial condition and standing as are considered necessary and appropriate to regulate the quality of financial institutions whose letters of credit will be acceptable to the commissioner.*"

The SVO has encountered several recent situations in which a financial institution on the QUSFI list (e.g. Silicon Valley Bank and Signature Bank) was not downgraded below the minimum permitted ratings of BBB-/Baa3 in the QUSFI guidelines in Part Two of the Purposes and Procedures Manual prior to regulatory action being taken by their primary regulator(s), such as closure of the bank by the relevant state regulator and appointment of the Federal Deposit Insurance Corp. as receiver. These situations accelerated very rapidly, and the most recent financial statements did not reflect sufficient financial weakness to warrant adding these financial institutions to the QUSFI Watch List.

It should be noted that, pursuant to a drafting note in Section 3 of Model #785, in order to limit market disruptions, when a QUSFI is removed from the list, any existing LOCs issued by it will continue to be acceptable as security until the beneficiary has replaced the credit support facility:

> **Drafting Note**: Providing for the continuing acceptability of letters of credit whose issuers were acceptable when the credit support facility was first obtained is intended to avoid abrupt interruptions in the acceptability of credit support arrangements that run for specific periods of time, and thus unnecessary disruptions in the marketplace, on account of the issuing (or confirming) institution's subsequent failure to meet applicable standards of issuer acceptability (whether by virtue of a change in the issuing institution's ability to qualify under the original

standards or as a result of revisions to the applicable standards). The provision stipulates that letters of credit acceptable when first obtained will, in the event of the subsequent nonqualification of the issuing (or confirming) institution, continue to be acceptable as security until the account party and beneficiary would first have, in the normal course of business, an opportunity to replace the credit support facility.

Recommendation – The SVO recommends updating the guidelines for removal of a financial institution from the List of Qualified U.S. Financial Institutions to include actions either announced or taken by their primary regulator(s).

Proposed Amendment - The proposed text changes to the P&P Manual are shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2022 P&P Manual format.

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

. . .

SVO Monitoring of Movements in the Credit Quality of Financial Institution on the List of Qualified U.S. Financial Institutions

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135. **Notice of Credit Deterioration** – The SVO shall provide notice to the NAIC Reinsurance (E) Task Force and state insurance regulators more generally and to insurers about the credit quality of financial institutions on the List of Qualified U.S. Financial Institutions as described below.

- If a financial institution is rated by an NRSRO at "A-/A3" or better and the SVO determines that a financial institution no longer meets one or more of the financial metrics specified above, the SVO will monitor the institution to assess the likelihood of the NRSRO to take a potential negative rating action against the institution.
- If the SVO determines that a financial institution on the List of Qualified U.S. Financial Institutions rated "BBB+/Baa1 or below but not lower than BBB-/Baa3" by an NRSRO no longer meets one or more of the financial metrics specified above or that it has been placed on Negative Outlook or Negative Watch by an NRSRO, the SVO shall perform a more detailed review of the financial condition of the institution.
- If the SVO determines that the noted credit deterioration suggests that the financial institution may soon no longer meet the required minimum, the SVO will place the name of the financial institution on its Watch List. If the name of the financial institution is placed on the SVO Watch List, the financial institution will not be allowed to renew participation on the financial institution list for the next year.
- If a financial institution on the List of Qualified U.S. Financial Institutions is downgraded below "BBB-/Baa3" by an NRSRO, the SVO shall remove the name of the financial institution from the List of Qualified U.S. Financial Institutions.
- If a financial institution on the List of Qualified U.S. Financial Institutions is closed by and/or placed in receivership or conservatorship, or notice is given of such action, by its primary regulator(s), the SVO shall promptly remove the name of the financial institution from the List of Qualified U.S. Financial Institutions. This may result in the SVO being unable to provide Notice of Credit Deterioration.

- A financial institution whose name is deleted from the List of Qualified U.S. Financial Institutions because its NRSRO credit rating dropped below the minimum credit rating may renew participation on the financial institution list when the financial institution's credit rating is restored to BBB-/Baa3 or higher with a stable outlook.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-03-23 Spring NM/06-QUSFI Credit Deterioration/2023-004.01 Task Force 2022 Amend PP QUSFI Credit Deterioration v3.docx

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Carrie Mears, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

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

RE: SVO 2022 Carry Over Filings

DATE: March 3, 2023

For 2022 the SVO reviewed 12,983 filings comprised of 3,562 initial filings, 9,291 annual updates, 70 material changes, and 17 appeals. In comparison, in 2021 the SVO reviewed 12,358 filings comprised of 3,199 initial filings, 7,932 annual updates, 208 material changes and 13 appeals. The total filing numbers included 1,961 manually processed private rating letters versus 1,953 in 2021.

TYPE	ANNUAL	INITIAL	APPEALS	MATERIAL CHANGE	RENUMBERING REQUEST	TOTAL
Appeals			16			16
Corporate	5,241	1,174	1	8	41	6,465
Counterparty Derivative	55	7	0			62
ETF	160		0			160
Municipal	161	142	0			303
Mutual Fund	168	8	0			176
Private Letter	363	1,598	0			1,961
QUSFI	137	7	0			144
Regulatory Transaction	7		0			7
RTAS		43	0			43
Sovereign	27	3	0	1		31
Structured Securities	2,972	580	0	61	2	3,602
Grand Total	**9,291**	**3,562**	**17**	**70**	**43**	**12,983**

There were also 1,199 carry-over filings for year-end 2022 versus 828 in 2021, 381 of which received a "IF" for an accepted initial filing and 818 received a "YE" for an accepted annual update. This represented a carry-over rate for 2022 of 9.2% which was higher than the 6.7% rate the SVO experienced in 2021. The carry-over rate is below the rate of 10% or higher that would be considered concerning and reflective of

a resource constraint for the office, but it is close and we will be monitoring the situation. The SVO had one position open for six-months and another analyst on leave for two-months at year-end that contributed to the higher carry-over rate, both situations have since been resolved. Overall, this was excellent performance by our group. As of March 1st, there were still 395 carry-over filings remaining.

As has been mentioned previously, the office continues to experience significant resource limitations regarding technology support that impacts our ability to improve our core systems, VISION, AVS+ and STS, or fully utilize our investment data. If additional analytical tasks are assigned to the SVO, which we are always happy to take on for the Task Force, additional SVO analysts or other resources may be needed.

We were also asked to summarize the range of industries the SVO reviews. On the following page is a summary by 77 major industry groupings out of the 314 different Standard Industrial Classification system codes (SIC Code) on which we received filings. There were 9,070 filings in 2022, or 70%, with SIC Codes with the remainder either being securities that did not have the SIC Code identified in the data or were some other filing type (e.g. replication synthetic asset transactions, structured settlements, etc.).

Major Industry Group	Number of Filings	% of Filings
Agricultural Production Crops	15	0.1%
Agricultural services	26	0.2%
Agriculture Production Livestock and Animal Specialties	4	0.0%
Amusement and recreation services	113	0.9%
Apparel and accessory stores	7	0.1%
Apparel and other finished products made from fabrics and similar materials	23	0.2%
Automotive dealers and gasoline service stations	20	0.2%
Automotive repair, services, and parking	47	0.4%
Building Construction General Contractors and Operative Builders	35	0.3%
Building materials, hardware, garden supply, and mobile home dealers	19	0.1%
Business services	399	3.1%
Chemicals and allied products	214	1.6%
Coal mining	11	0.1%
Communications	56	0.4%
Construction Special Trade Contractors	83	0.6%
Depository institutions	121	0.9%
Eating and drinking places	33	0.3%
Educational services	192	1.5%
Electric, gas, and sanitary services	2026	15.6%
Electronic and Other Electrical Equipment and Components, except Computer Equipment	230	1.8%
Engineering, accounting, research, management, and related services	201	1.5%
Executive, legislative, and general government, except finance	16	0.1%
Fabricated metal products, except machinery and transportation equipment	62	0.5%
Fishing, hunting, and trapping	10	0.1%
Food and kindred products	283	2.2%
Food stores	126	1.0%
Forestry	9	0.1%
Furniture and fixtures	13	0.1%
General merchandise stores	8	0.1%
Health services	184	1.4%
Heavy Construction Other Than Building Construction Contractors	43	0.3%
Holding and other investment offices	503	3.9%
Home furniture, furnishings, and equipment stores	5	0.0%
Hotels, rooming houses, camps, and other lodging places	15	0.1%
Industrial and commercial machinery and computer equipment	222	1.7%
Insurance agents, brokers, and service	34	0.3%
Insurance carriers	151	1.2%
Leather and leather products	2	0.0%
Legal services	2	0.0%
Local and suburban transit and interurban highway passenger transportation	20	0.2%
Lumber and wood products, except furniture	33	0.3%
Measuring, Analyzing, and Controlling Instruments; Photographic, Medical and Optical Goods	135	1.0%
Membership organizations	9	0.1%
Metal mining	24	0.2%
Mining and quarrying of nonmetallic minerals, except fuels	35	0.3%
Miscellaneous manufacturing industries	41	0.3%
Miscellaneous repair services	1	0.0%
Miscellaneous retail	47	0.4%
Miscellaneous Services	7	0.1%
Motion pictures	4	0.0%
Motor freight transportation and warehousing	57	0.4%
Museums, art galleries, and botanical and zoological gardens	6	0.0%
National security and international affairs	7	0.1%
Nonclassifiable Establishments	18	0.1%
Non-Depository Credit Institutions	308	2.4%
Oil and gas extraction	123	0.9%
Paper and allied products	66	0.5%
Personal services	23	0.2%
Petroleum refining and related industries	16	0.1%
Pipelines, except natural gas	41	0.3%
Primary metal industries	20	0.2%
Printing, publishing, and allied industries	42	0.3%
Private households	6	0.0%
Public finance, taxation, and monetary policy	18	0.1%
Railroad transportation	23	0.2%
Real estate	1135	8.7%
Rubber and miscellaneous plastics products	44	0.3%
Security and commodity brokers, dealers, exchanges, and services	91	0.7%
Social services	39	0.3%
Stone, clay, glass, and concrete products	49	0.4%
Textile mill products	12	0.1%
Transportation by air	191	1.5%
Transportation equipment	216	1.7%
Transportation services	177	1.4%
Water transportation	130	1.0%
Wholesale Trade-Durable Goods	172	1.3%
Wholesale Trade-Non-Durable Goods	121	0.9%
Unclassified and Other	3913	30.1%
Grand Total	**12983**	**100.0%**

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-03-23 Spring NM/07-SVO Year-end Carry-over Filings/2023-003.01 SVO Carry Over Filings 2022.docx