VALUATION OF SECURITIES (E) TASK FORCE

Valuation of Securities (E) Task Force October 20, 2022, Interim Meeting Minutes (Attachment One)
Valuation of Securities (E) Task Force 2022 Summer National Meeting Minutes (Attachment Two)

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. 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

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.

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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

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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

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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.

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Valuation of Securities (E) Task Force
Virtual Meeting
October 20, 2022

The Valuation of Securities (E) Task Force met Oct. 20, 2022. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Scott A. White, Vice Chair, represented by Doug Stolte (VA); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone and Kathryn Belfi (CT); 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 Jim Everett (NY); Cassie Brown represented by Amy Garcia (TX); Jon Pike represented by Jake Garn (UT); and Mike Kreidler represented by John Jacobson (WA).

1. Adopted its 2023 Proposed Charges

Mears said the first item is to consider adoption of the Task Force's 2023 proposed charges. Most of its 2023 proposed charges are unchanged from 2022. However, there are two additional charges for 2023, with some clean-up references to other groups. The new charges are as follows:

- *J. Establish criteria to permit staff's discretion over the assignment of NAIC designations for securities subject to the filing exempt (FE) process (the use of credit rating provider [CRP] ratings to determine an NAIC designation) to ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives.*
- *K. Implement additional and alternative ways to measure and report investment risk.*

Charge J is a continuation of the existing charge "I," which says that the Task Force will: "*Implement policies to oversee the NAIC's staff administration of rating agency ratings used in NAIC processes, including staff's discretion over the applicability of their use in its administration of filing exemption.*" This new charge would begin establishing what criteria is needed for when staff's discretion is permitted.

Charge K is consistent with the fixed income analytical risk measures the Task Force is considering. That effort is supported by the regulators of the Financial Stability (E) Task Force and Macroprudential (E) Working Group as mentioned in their referral to this Task Force dated July 21, 2022. Referrals will be sent to a number of NAIC groups requesting their feedback based on the last exposure from the Summer National Meeting.

Mears said that no comment letters were received on the Task Force's proposed charges.

Michael Murray (Paul Hastings LLP on behalf of Egan Jones Rating Company) said the proposed change in the charges, which empowers the NAIC to overrule and disregard ratings provided by private firms, would be a significant mistake. He said the Securities Valuation Office (SVO) is in a unique position. It is both a de facto regulator through updates to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) and a market participant by way of the issuance of designations, which act in a manner similar to ratings. This dual role of being both a regulator and a market participant gives rise to numerous complex issues and provides both the opportunity and the motivation to steer business to itself.

Murray said this is not an idle concern, as the SVO has effectively monopolized ratings or designations in the following areas: principle protected securities (PPS), exchange-traded funds (ETFs), credit tenant loans (CTLs), and ground lease financing (GLF) transactions, until that was partially reversed. He said the change in the charges is the latest in a series of actions that are contrary to the will of the U.S. Congress, which sought to encourage "additional competition" in the ratings arena. He said that although the SVO claims its assessments are different from those of private firms, that is a feature, not a bug of the congressionally ordained regime, which is designed to foster diversity and competition in the space and indeed even forbids regulators from "regulating the substance of credit ratings or the procedures of methodologies by which any private firm determines credit ratings."

Murray said there is little evidence that SVO assessments are superior to those of private firms. Unlike private firms, the SVO has no public methodologies, no separation of the analytics from the business side, no mandatory review of models and methodologies, no review of policies and procedures by a party such as the U.S. Securities and Exchange Commission (SEC), and no deep wellspring of expertise. The notion that the SVO's ratings are superior because they are lower also is flawed. The goal is timely, accurate ratings, not to depress ratings, which have the effect of depriving insurance company investors of attractive returns for policyholders. Just a few months ago, a large firm in the ratings space proposed to adopt a methodology that would have steered issuers and investors to the uses of its ratings. They appear to have abandoned that proposal in the face of comments from various bodies, including the U.S. Department of Justice (DOJ), stating that the proposal could raise significant concerns under the antitrust laws. The charges here and related actions raise an analogous conflict of interest. Murray said that he would be happy to address the nuanced specifics of the antitrust issues. He said the main message is that the changes in the charges are not appropriate, and he urged the deferral of any action on the charges.

Mears said these charges are not changing anything at this point. Any allowances for what the SVO staff will do with the charges is to establish any sort of criteria for when that discretion would be used. As that criteria goes through the normal due process, Mears said the Task Force welcomes Murray and the group he is representing to comment under the formal comment process, when it is exposed, and continue to have this conversation.

Charles A. Therriault (NAIC) said that this is an open process and that the Task Force welcomes feedback from all interested parties.

Stolte made a motion, seconded by Crawford, to adopt the Task Force's 2023 proposed charges (Attachment). The motion passed unanimously.

2. Discussed and Exposed a Proposed P&P Manual Amendment to Include CLOs as a Financially Modeled Security in Part Four

Mears said the next item is to discuss comments and consider for exposure a proposed amendment to the P&P Manual to add reporting instructions for the financial modeling of collateralized loan obligations (CLOs).

Eric Kolchinsky (NAIC) said this proposal seeks to be the first step in allowing the Structured Securities Group (SSG) to go through the process of modeling CLOs. This step is necessary to begin planning the budgetary items. As discussed, this will be followed by a release and exposure of a methodology, which is the pipelines, as well as the scenarios, which will probably be the most controversial or, at least, a more deliberative step in the process. He said this allows the SSG to kick the process off and, to the extent some of this needs to be amended later, open to those changes to make sure everything fits the process that has been discussed and deliberated. At this point, the SSG is only looking to model the broadly syndicated loans CLOs. The intention is to eventually model the middle market CLOs, but they will be out of scope, at least in the first round of this implementation.

Mears said this is the first step in the process and somewhat procedural for budgetary reasons. She said there may need to be amendments later as the deliberations around the methodology and scenarios occur. An informational referral will be prepared for the Risk-Based Capital Investment Risk and Evaluation (E) Working Group to continue the coordination with that Working Group and to continue discussions on the risk-based capital (RBC) components. One comment letter was received from the American Council of Life Insurers (ACLI) on the exposure of the Capital Markets Bureau (CMB) CLO stress test methodology, year-end 2020 CLO stress test results, and SSG staff responses to previously received comment letters on a topic.

Mike Monahan (ACLI) said there was nothing further to add as this was an exposure.

Mears directed staff to expose the proposed P&P Manual amendment to include CLOs as a financially modeled security in Part Four for a 45-day comment period ending Dec. 5 and directed staff to refer the amendment to the Risk-Based Capital Investment Risk and Evaluation (E) Working Group.

3. Discussed Comments and Exposed a Proposed Amendment to the P&P Manual to Update Instructions for Related Party and SCA Investments

Mears said the next item is to receive, discuss, and consider for exposure a proposed amendment to the P&P Manual to update instructions for related party and subsidiary, controlled, and affiliated (SCA) investments.

Marc Perlman (NAIC) said this agenda item stems from a referral from the Statutory Accounting Principles (E) Working Group. On June 10 the Working Group sent a referral to the Task Force resulting from the Working Group's May 24 adoption of agenda item 2021-21: Related Party Report, which 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 FE for various affiliated structures.

The 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 this matter to the Task Force, stating "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 special purpose entity (SPE) issuer, originator, sponsor or servicer rather than the underlying obligor] qualify for FE."

The Subsidiary, Controlled and Affiliated (SCA) Debt or Preferred Stock Investments section of the P&P Manual currently only requires insurers to file with the SVO bonds or preferred stock issued by an SCA entity. Therefore, a transaction with an affiliate or related party originator, sponsor, manager, or underlying obligor (credit exposure), as opposed to issuer, would not constitute an SCA investment as currently defined.

The SVO proposes amending the SCA section of the P&P to clarify that investments with related or affiliated SPE issuers or originators, sponsors, managers, or other similar parties of structured transactions will qualify for FE, unless a regulator refers it to the SVO for review, in which case it will be removed from FE. However, investments with related or affiliated underlying credit exposure (such as the obligors) could be ineligible for FE, even though the issuer is not affiliated or related.

First, structured transactions with affiliate or related parties that are not credit exposures (such as issuer SPEs, originators, sponsors, etc.) could, as stated in SSAP No. 25, be "subject to abuse because reporting entities may

be induced to enter transactions that may not reflect economic reality or may not be fair and reasonable to the reporting entity or its policyholders." For example, an affiliated or related entity could originate several loans to unaffiliated and unrelated obligors and, for various reasons, sell those loans to an SPE, which could then issue a note to the reporting insurance company. The fact that the reporting insurance company is assuming the risk of the loans originated by an affiliate or related party could pose risks of abuse or unfairness even though neither the issuer nor the underlying loan obligors (the credit exposure) are affiliates or related parties. Transactions like this in which an affiliate or related party is not the issuer (typically a securitization or other structured finance transaction) are currently eligible for FE, and this amendment does not propose changing that. Such investments, however, would likely be in scope of SSAP No. 25 and subject to reporting as an affiliate or related party transaction in the appropriate investment schedules. State insurance regulators could, based upon the reporting of an affiliate or related party relationship, require that the reporting insurance company file an investment with the SVO for analysis and/or assignment of an NAIC designation, thereby removing it from the FE process.

A similar risk of possible abuse or unfairness exists if the underlying credit exposure has a relationship to the reporting insurance company, even if the issuer does not. Since, currently, only the relationship with the issuer determines whether the investment is ineligible for FE, the amendment proposes amending the SCA section of the P&P Manual so that certain investments with affiliated or related underlying credit exposure would also not be eligible for FE. The risk of abuse due to an affiliate or related underlying credit exposure could be minimal if the affiliate or related party obligors only constitute a small portion of the total underlying credit exposure, or very pronounced if they constitute a large portion. Therefore, the SVO recommends that only those investments that would qualify as a related party pursuant to paragraph 4.a. in SSAP No. 43R, due to affiliated or related party underlying credit exposure, be ineligible for FE.

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

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

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

Tsang asked what the SVO criteria is to determine whether a filed SCA and related party investment has term structure, complexity, and purpose like those transactions of unaffiliated parties. Is there a manual or standard

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procedure for doing that? Mears said the Statutory Accounting Principles (E) Working Group, for year-end 2022, added a column to describe the nature of the affiliation for a particular investment, recognizing that any investment that has some sort of affiliate in nature should be reported on that affiliate investment line, but not all of them may have underlying credit exposure. There may be instances in which the asset manager would like the structure of the CLO that otherwise would be an affiliated credit exposure. There will be clarity into that as of year-end 2022. This is meant to provide clarification in those instances that would otherwise be an unaffiliated exposure, but the asset manager provided origination or structuring, and those transaction would still qualify for FE.

Tsang asked if the SVO already has criteria to make that determination and that companies should be able to follow it. Therriault said the SVO reviews the legal documents and the relationships that exist within those legal documents when it makes an assessment. It is not published criteria that insurers can follow. The related party example that Perlman gave would not have been something that would have been easily picked up on when there is a father-and-son relationship. The SVO analysts, through additional research, were able to make that connection. Some relationships are more transparent than others.

Tsang asked if a company has an investment being classified as an affiliated party and wants to make it unaffiliated, does the industry have any means of rectifying that. Mears said they should be following the SCA guidance that is defined by the Statutory Accounting Principles (E) Working Group, and that would be outside the purview of this group. That would be the responsibility of the insurer to make those identifications.

Therriault said the SVO are following the definition in the *Accounting Practices and Procedures Manual* (AP&P Manual) and is addressing the changes adopted to make sure that it is consistent with the AP&P manual. Mears said that would be a reporting question on how to apply the statutory guidance and probably a discussion for the Statutory Accounting Principles (E) Working Group.

Mears directed SVO staff to expose this proposed amendment to the P&P Manual to update instructions for related party and SCA investments for a 45-day public comment period ending Dec. 5.

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

Mears said the next agenda item is to receive, discuss, and consider exposure of a proposed amendment to clarify the definition of an NAIC designation in Part One and Part Two of the P&P Manual.

Therriault said NAIC designations are a specific risk measure created for NAIC regulatory purposes. They are not, and should never be, considered the functional equivalent of a rating from a rating agency, including nationally recognized statistical rating organizations (NRSROs) recognized and regulated by the U.S. SEC's Office of Credit Ratings (OCR). The purpose of NAIC designations, administered through the SVO, is to ensure that investments in securities made by state-regulated insurance companies satisfy objective and consistent standards for credit quality and, therefore, accurately reflect those companies' financial solvency as required by individual states. While some NAIC designations under the FE rule may be based upon a CRP rating mapped to a corresponding NAIC designation, the mere fact that a CRP rating could be converted to an NAIC designation does not, and never has, meant that the two are interchangeable. As noted in Part One of the P&P Manual, "The VOS/TF is resolved that the benefit obtained from the use [of] credit rating in state regulation of insurance must be balanced against the risk [of] blind reliance on credit ratings. To ensure the Task Force properly understands the composition and risk of the filing exempt securities population; promote uniformity in the production of NAIC Designations, reduce reporting exceptions for filing exempt securities and increase the efficiency of this NAIC process, the SVO and SSG

(hereafter, the IAO) is charged with administration of the filing exempt process defined in Part Three of this Manual."

The updates being proposed to Part One and Part Two of the P&P Manual are intended to further clarify that NAIC designations are specifically intended to reflect their use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) that have been incorporated into state law by the states as participants in the Accreditation Program administered by the Financial Regulation Standards and Accreditation (F) Committee. It will also conform the definition of an NAIC designation in these two parts. The updated language will clarify three issues that are intrinsic to assessing investment risk for regulatory purposes and the use of NAIC designations:

- 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 SFRS.

The SVO believes that these changes will improve clarity as to the purpose of NAIC designations in these two sections of the P&P Manual and how they should be interpreted by anyone using an NAIC designation. The SVO recommends that this amendment also be exposed for a 45-day comment period.

Chris Anderson (Anderson Insights) said that Therriault's presentation was different from the proposal itself and contained additional information. Anderson said he supports the idea of clarifying the definition of an NAIC designation and noted that the proposal itself makes it clear that an NAIC designation is a credit designation and does not involve liquidity or call features. In summary, Anderson said he thinks the proposal should be focused not on how an NAIC designation is used and perhaps abused, which he said seems to be the focus of this proposal. If the objective is to clarify the definition of an NAIC designation, it should be clarified. An NAIC designation is consistent in the P&P Manual as it relates to credit, and he said part of this proposal is spot on. Credit is the ability and willingness of an obligor to make payments. A credit rating encompasses any reason that an obligor may fail. It does not matter what kind of asset it is. Credit rating on a scale of 1–20 reflects the probability of timely payment or default. Some of the language proposed is appropriate. Some of the other language, such as consistency, is not relevant to the definition of what an NAIC designation is. An NAIC designation is only credit. These thoughts should be referred to the Capital Adequacy (E) Task Force so that there can be consistency throughout the NAIC as to the meaning of an NAIC designation because RBC factors for bonds and preferred stock are based on the concept of credit.

Mears said Therriault detailed the reasons NAIC designations are unique, and clearly credit is a major component of that. They are used really for the sole purpose of the insurance regulatory framework, and RBC is a large part of that. The way that those are intertwined cannot be denied, and there is a connection that needs to be acknowledged. She said that Anderson's point as to the timely and ultimate payment of principal and interest is something the Task Force is concerned with, and it can be discussed further upon receipt of his letter.

Mears directed staff to expose the proposed amendment to clarify the definition of an NAIC designation in Part One and Part Two of the P&P Manual for a 45-day public comment period ending Dec. 5.

5. Discussed Any Other Matters

Kolchinsky said regarding the interval release of the residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS), data reflect the 20 NAIC designation categories, and recent developments should be released around Oct. 31.

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-12 - Fall National Meeting/01-Minutes/Att One VOSTF 10.20.22 Minutes v6 (FINAL).docx

Draft: 8/23/22

Valuation of Securities (E) Task Force
Portland, Oregon
August 11, 2022

The Valuation of Securities (E) Task Force met in Portland, OR, Aug. 11, 2022. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Scott A. White, Vice Chair, represented by Greg Chew (VA); Lori K. Wing-Heier represented by David Phifer (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Virginia Christy (FL); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett and John Rehagen (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); Jon Pike represented by Jake Garn (UT); Mike Kreidler represented by Steve Drutz (WA).

1. Adopted its June 9 and Spring National Meeting Minutes

Ms. Mears said the first item is to consider adoption of the Task Force's June 9 and Spring National Meeting minutes. Michael M. Monahan (American Council of Life Insurers—ACLI) provided one comment in advance on the Spring National Meeting minutes. He asked that one sentence be clarified on the topic of the use of designations by non-U.S. jurisdictions. It currently reads, "Mr. Monahan said to address two jurisdictions, Japan FSA and the BMA, US dollar private placements are currently a core asset class … ," which is not an easily readable sentence. The recommended update to the final minutes will be made and read, "Mr. Monahan said *this proposal is meant* to address two jurisdictions, Japan FSA and the BMA, *where* US dollar private placements are currently a core asset class … ."

Ms. Doggett made a motion, seconded by Ms. Clements, to adopt the Task Force's June 9 (Attachment One) and April 5 (*see NAIC Proceedings – Spring 2022, Valuation of Securities (E) Task Force*) minutes. The motion passed unanimously.

2. Discussed Comments and Adopted a Proposed Amendment to the P&P Manual Clarifying the Role of the SVO Regarding Interpreting Accounting and Reporting

Ms. Mears said the next item is to discuss comments and consider adoption of a proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to clarify the role of the Securities Valuation Office (SVO) regarding interpreting accounting and reporting.

Marc Perlman (NAIC) said the SVO has historically worked with statutory accounting colleagues to make accounting and reporting determinations, which guided whether the SVO could analyze and designate an insurer's investment. However, the P&P Manual currently provides conflicting guidance on whether the SVO should have a role interpreting accounting and reporting guidance. Paragraphs 32, 33, and 34 of Part One of the P&P Manual state that: 1) the assessment of an investment's credit risk is distinct from the determination of statutory accounting or reporting under the *Accounting Practices and Procedures Manual* (AP&P Manual); 2) accounting

and reporting determinations for investments are the obligation of the insurance company, but state insurance regulators remain the final authority; and 3) the SVO may assign NAIC designations to any investment filed with it for which it has a methodology. However, it is also specified in Part One, paragraph 40 that the SVO is assigned to assess investments reported only on Schedules D and BA and shall communicate to insurers if an investment is not eligible for those schedules and can therefore not be assigned an NAIC designation. The SVO recommends amending paragraph 40 to provide consistent instructions to the SVO regarding its accounting and reporting guidance authority. The proposal would clarify, in accordance with Part One, paragraph 34, that the SVO can assign NAIC designations to investments that it does not believe are eligible for Schedule D or BA reporting so long as it has the methodology to do so. However, the SVO would have the authority, at its discretion, to notify the appropriate state insurance regulators of any investments that, in its opinion, would not or might not be eligible for reporting on Schedules D or BA. The SVO would also maintain its authority to offer its accounting and reporting opinion, when requested to do so, as part of its Regulatory Treatment Analysis Service (RTAS), it being understood that such opinions would not be authoritative and might not reflect the opinion of the relevant state insurance regulator. Also, to be clear, the SVO would not be required to designate investments that deviate from specific guidelines in the P&P Manual for that investment type. For example, for the SVO to designate a working capital finance investment (WCFI), the investment will still need to meet the very specific WCFI guidelines currently in the P&P Manual.

The SVO recommends adoption of the amendment, as exposed. There was a proposed change submitted by the ACLI, the Private Placement Investors Association (PPiA), and the North American Securities Valuation Association (NASVA) in their joint comment letter that would require the SVO to also notify the filing company or the company on which the SVO is providing its opinion. The SVO strongly recommends that this additional change not be included. The mission of the SVO, as explained in the P&P Manual, is to "support the financial solvency objectives of state regulators." The SVO's role is to support state insurance regulators, who, pursuant to paragraph 33, are the ultimate arbiters of accounting and reporting. It is the state insurance regulators' role to direct insurers on proper accounting and reporting. Additionally, requiring the SVO to inform companies of its regulatory opinion could interfere with the SVO's ability to have confidential discussions with state insurance regulators on matters that can, and have, involved not only regulatory but, even, criminal action.

Ms. Mears said this is ultimately somewhat of a formality, as the Statutory Accounting Principles (E) Working Group has clearly continually stated that the existence of an NAIC designation does not define the accounting treatment of an investment, and thus formalizes that assumption in the P&P Manual as well. To Mr. Perlman's point about not making the edit proposed in the ACLI joint comment letter, the Task Force encourages transparent and collaborative discussion between the SVO and insurers, but there may be times where that is not appropriate, particularly when there is confidential action needed, which is why this requirement should not be put into the P&P manual.

Michael Reis (Northwestern Mutual), on behalf of the ACLI, the PPiA, and NASVA, said these groups understand the rationale for not including that language and support the proposal as suggested.

Chris Anderson (Anderson Insights LLC) said he hopes there would be symmetry between what the analyst at the SVO considers to be a bond and what will appear in the statutory accounting principles. Designations and credit ratings are expressions of the probability of payment on a scale of 1 to 20. If there is a probability of payment on a scale of 1 to 20, that indicates that the asset is a bond. It does not mean state insurance regulators should not have additional information about what kind of bond it is, but it seems that the most important element of investing in fixed income is whether there will be repayment. When the SVO or another analyst has expressed a

considered view, reviewing all the facts and circumstances in an individual asset, it would seem to be compelling evidence. Mr. Anderson also hopes there will be coordination between the Task Force, the Statutory Accounting Principles (E) Working Group, and Capital Adequacy (E) Task Force.

Mr. Phifer made a motion, seconded by Mr. Chew, to adopt the amendment to clarify the roles of the SVO regarding interpreting accounting and reporting (Attachment Two). The motion passed unanimously.

3. Discussed Comments and Adopted a Proposed Amendment to the P&P Manual to Update Part Four for NAIC Designation Categories and Additional Price Points

Ms. Mears said the next item is to discuss comments and consider adoption of a proposed amendment to the P&P Manual to update Part Four for NAIC Designation Categories and additional price points.

Charles A. Therriault (NAIC) said, as noted in the memo, this amendment reflects the adoption of new risk-based capital (RBC) factors for each NAIC Designation Category in 2021 by the Capital Adequacy (E) Task Force and the Financial Condition (E) Committee, and it proposes the technical updates needed in the P&P Manual to reflect a consistent reference to "NAIC Designation Category" and the additional price points needed to determine them. A joint comment letter was received from the ACLI, the PPiA, and NASVA supporting the proposed change.

Mr. Reis, on behalf of the ACLI, the PPiA, and NASVA said these groups support the proposed changes.

Ms. Brown made a motion, seconded by Ms. Doggett, to adopt the amendment to update Part Four for NAIC Designation Categories and additional price points (Attachment Three). The motion passed unanimously.

4. Discussed Comments and Adopted a Proposed Amendment to the P&P Manual to Update the Definition of PPS

Ms. Mears said next item is to discuss comments and consider adoption of a proposed amendment to the P&P Manual to update the definition of principal protected securities (PPS).

Mr. Perlman said the SVO has proposed amending the P&P Manual definition of PPS because it is seeing transactions that pose similar risks to PPS transactions, as currently defined in the P&P Manual, but which are structured in a way that does not cleanly fit the current definition, which requires "underlying investments."

These new securities could be described as "synthetic PPS" because they are not issued by a special purpose vehicle (SPV) holding an "underlying" principal protection bond and performance asset. Instead, the security is the direct obligation of a large financial institution, which is obligated to pay principal at maturity and a premium based on the performance of referenced assets, such as equity, fixed-income or futures indices (or a combination thereof), and other financial assets. Though the obligation is solely that of the issuing financial institution, meaning there are no underlying bonds or performance assets, the structure poses the same risk of exposure to a performance asset because the amount of the issuer's payment obligation is directly dependent on the performance of the referenced indices or assets. Additionally, unlike a PPS transaction with an underlying bond and performance asset, the likelihood of payment of the performance asset premium, whatever the amount might be, is linked directly to the creditworthiness of the issuer.

Following the introduction of this topic at the 2021 Fall National Meeting, comments were received from interested parties that they agreed with the substance behind the proposed amendment but requested that the wording be thoroughly discussed, as was the case with the original P&P Manual definition. At the Spring National Meeting this amendment was re-exposed for an additional 30 days. The current proposed amendment, which reflects comments from industry, expands the PPS definition to capture the structures that did not meet the original definition, yet which posed the same risks.

Mr. Reis, on behalf of the ACLI, the PPiA, and NASVA, said they are very supportive of the proposed amendment and are optimistic that it is structured in a way, principle-based, not unlike the bond definition, which will help address the risk once and for all.

Mr. Fletcher made a motion, seconded by Ms. Clements, to adopt the P&P Manual amendment to update the definition of PPS (Attachment Four). The motion passed unanimously.

5. Received and Discussed a Referral from the Statutory Accounting Principles (E) Working Group on the Adoption of Agenda Item 2021-21

Ms. Mears said the Task Force received a referral from the Statutory Accounting Principles (E) Working Group regarding the adoption of agenda item 2021-21: Related Party Reporting. The purpose of the referral was to notify the Task Force that the Working Group adopted agenda item 2021-21 and recommend that the Task Force assess whether edits to the P&P Manual are necessary resulting from comments raised regarding filing exemption (FE) for affiliated structured securities with unaffiliated credit exposure. The SVO is reviewing the referral to determine whether it needs to develop additional procedures or clarify that the instructions for affiliated investments that do not have underlying affiliated credit exposure qualify for FE. If so, a proposed amendment will be brought to the Task Force for potential exposure at an upcoming meeting. There is no action required from the Task Force at this time, and it will follow up later with any potential amendments.

Ms. Mears directed SVO staff to continue their review and, if needed, draft a proposed P&P Manual amendment to clarify the related party instructions.

6. Received and Discussed a Referral from the Macroprudential (E) Working Group on its Plan for the List of MWG Considerations

Ms. Mears said the Task Force received a referral from the Macroprudential (E) Working Group of the Financial Stability (E) Task Force. The Working Group was charged with coordinating the various NAIC activities related to private equity (PE)-owned insurers. As an initial step, the Working Group developed a list of 13 regulatory considerations, which is included in the materials. The list included three items specific to either the Valuation of Securities (E) Task Force or the work of the SVO.

First, the Risk-Focused Surveillance (E) Working Group is considering the material terms of the investment management agreements (IMAs) and whether they are arm's length or include conflicts of interest. In the state insurance regulator discussions, it was noted, "Given the increasing prevalence of bespoke agreements, does it make sense to tie this work in to the work of the NAIC Valuation of Securities (E) Task Force and/or the NAIC Securities Valuation Office? If yes, how best to do so?"

Second, the Working Group is considering the material increases in privately structured securities, both by affiliated and non-affiliated asset managers, which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk. To assist state insurance regulators in identifying concerns with these investments, state insurance regulators expressed support for the Task Force proposal to obtain market yields to allow a comparison with the NAIC designation. Once such data is available, state insurance regulators ask NAIC staff to develop a tool or report to automate this type of initial screening. Also, state insurance regulators again recognized that the Statutory Accounting Practices (E) Working Group Schedule D revamp work will help in identifying other items for initial screening.

Third, the Risk-Focused Surveillance (E) Working Group is considering the level of reliance on rating agency ratings and their appropriateness for regulatory purposes (e.g., accuracy, consistency, comparability, applicability, interchangeability, and transparency). The Task Force has previously addressed and will continue to address this issue. A small ad hoc group was formed—i.e., key representatives from NAIC staff, state insurance regulators, and industry—to develop a framework for assessing rating agency reviews. This will be a multi-year project, will include discussions with rating agencies, and will include the inconsistent meanings of ratings and terms. State insurance regulators agreed to monitor the work of the ad hoc group in lieu of any specific recommendations at this time. Recognizing that this will likely be a multi-year project, state insurance regulators reserve the right to raise specific concerns that may arise as the various NAIC committee groups work to address this list of considerations.

No specific action is required by the Task Force at this time other than receiving this referral and continuing its work on these initiatives.

It is important to highlight the Macroprudential (E) Working Group's, the Financial Stability (E) Task Force's, and Life Actuarial (A) Task Force's support for adding fixed income analytical risk measures to investments reported on Schedule D, Part One, a topic that will be discussed later.

7. Discussed, Received Comments, and Exposed the Proposed Task Force Charges for 2023

Ms. Mears said the next item is to discuss and consider for exposure the proposed Task Force charges for 2023. Most of the proposed charges for 2023 are unchanged from 2022. The two additional charges are as follows:

- J. Implement additional and alternative ways to measure and report investment risk.
- K. Establish criteria to permit staff's discretion over the assignment of NAIC designations for securities subject to the filing exempt process (the use of credit rating provider ratings to determine an NAIC designation) to ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives.

The first new charge is consistent with the fixed income analytical risk measures that will be discussed later. The second new charge is a continuation of the existing charge I that says the Task Force will "Implement policies to oversee the NAIC's staff administration of rating agency ratings used in NAIC processes, including staff's discretion over the applicability of their use in its administration of filing exemption." This charge would begin establishing when staff's discretion is permitted.

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The new charges will be reordered slightly since charge K is effectively a continuation of charge I and should follow it. Also, the existing charge G refers to the groups the Task Force will coordinate with; the new RBC Investment Risk and Evaluation (E) Working Group will be added.

Stephen Broadie (American Property Casualty Insurance Association—APCIA) said he appreciates the explanation that charge K is supposed to follow charge I. It seemed like it might possibly be a broad grant of authority to the staff, and he wanted to ensure how far that is intended.

Ms. Mears said the charge is to establish that the criteria and any criteria that would be proposed would go through the normal due process of exposure and comment by any interested parties.

Ms. Mears directed staff to re-order the new charges so that the text for charge J and charge K are switched, add the Working Group to charge G, and expose the Task Force's 2023 proposed charges for a 30-day public comment period ending Sept. 12.

8. Received and Discussed Comments and Next Steps on a Proposal to Add Fixed Income Analytical Measures for Investments Reported on Schedule D, Part One

Ms. Mears said the next item is to receive, discuss comments, and consider next steps on a proposal to add fixed income analytical measures for investments reported on Schedule D, Part One. This was first discussed at the Spring National Meeting and at the June 9 meeting. The proposed new fields will not only support the SVO's analytical processes, but they also align with the regulatory initiatives of the Capital Adequacy (E) Task Force, the Life Actuarial (A) Task Force, and concerns expressed by the Financial Stability (E) Task Force and its Macroprudential (E) Working Group, which looks at industry-level and systemic risk, including their plans to build regulatory dashboards to reflect those risks. The commonly used bond analytical fields in this request are interconnected, one way or another, to the investment risk analysis being performed by these other regulatory groups and will ultimately benefit the NAIC by strengthening its overall regulatory framework. This request is not new and relates back to the 2010 recommendation from the Rating Agency (E) Working Group to look for an alternative way to measure risk, but its implementation is long overdue.

There were concerns raised in the comment letters related to the operational burden of collecting this data and explanations as to the reasons why some investments may have a higher yield spread versus a U.S. Treasury that may not be related to credit risk, such as liquidity or complexity risk. As discussed at the June meeting, while these other risks may exist and influence an investment's yield, the NAIC's current framework does not separately capture them and encapsulates essentially all investment risk into the NAIC designation.

There were also suggestions to use total return measures, such as the Sharpe and Sortino ratios and performance attribution analysis to assess risk. These ratios are better suited for evaluating relative value than they are for identifying market risk premiums related to credit risk. Additionally, the system changes, data, pricing, and other information that would be required for insurers to calculate total return on each security, produce statistically significant annual standard deviations of those returns, as well as the performance attribution of each security would be a substantially greater burden on insurers than the proposed analytical fields. The Task Force respects the feedback from industry that this would be operationally burdensome, and it wants to look at alternative ways to collect this information.

SVO staff prepared a memo to consider optional paths and the operational issues to implementing this proposal. The memo outlines several benefits and two possible paths to deliver this information along with pros and cons of both.

Mr. Therriault said the SVO proposed adding these additional market data fields for bond investments to the annual statement for several reasons. The recommendation was based on 2010 adopted recommendations of the Rating Agency (E) Working Group, the NAIC Investment Analysis Office (IAO) staff's findings regarding the discrepancies between ratings, presented in its Nov. 29, 2021, memo, as well as the work and discussions occurring within other regulatory groups that are also trying to assess insurers' investment risk.

The SVO and the Structured Securities Group (SSG) have raised concerns over the past several years about asset classes and specific securities where a rating agency rating does not adequately reflect the investment risk for NAIC purposes. The SVO will use this analytical information to help it identify investment risk assessment inaccuracies, and, coupled with some level of discretion over NAIC designations derived from ratings, take potential action on them. Without this information and authority to act, there will continue to be a large incentive for RBC arbitrage utilizing CRP ratings. Rating agencies are effectively a de-facto "super regulator" today in that any investment security assigned a rating by any rating agency will automatically be accepted by the NAIC without any regulatory discussion, analysis, oversight, or consideration as to how the rating agency's decisions align to the NAIC's financial solvency framework.

As a ratings consumer with regulatory objectives unique to those of the rating agencies, the SVO believes there are several regulatory benefits to the NAIC collecting this additional market data:

- Assisting in SVO identification of securities with CRP ratings, which may be inconsistent with a security's actual overall risk for NAIC purposes.
- Greater transparency for state insurance regulators into the risks and characteristics of insurer investments and portfolios.
- Incorporation of insurer investment portfolio analysis into the examination process.
- Allowing state insurance regulators to assess the capabilities of an insurer's investment management or risk management processes by reviewing the quality and accuracy of the market data fields.

The SVO believes there are two primary alternatives to providing this information to the NAIC. The first alternative is to assign the SVO the responsibility of producing the analytical data elements requested in the proposal. This would require significant enhancements to the SVO's existing systems—VISION, AVS+, and STS—additional vendor pricing data; investments in new systems to provide the analytical modeling; additional staff for the incremental and ongoing support of these systems, processes, and data, along with reporting capabilities to provide this information to state insurance regulators. Enhancements would also include the ability for insurers to electronically provide the SVO with the full security structure of any investment that the modeling software does not know about. Insurers may still need to report this information on the statutory statements.

The second alternative would be to have insurers calculate this information and provide it to the NAIC, as originally proposed. As noted in the memo, insurer's investment managers should already have the market data fields requested in the proposal. Insurers would need to get this security issue level information (e.g., the Committee on Uniform Securities Identification Procedures [CUSIP]) into their systems that produce their Schedule D filings. This option would require more work up front on the part of the insurers and less work by the NAIC. The ultimate usefulness of the data, whether by state insurance regulators, the SVO, or other interested NAIC groups, could be

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significantly more limited than in the first option, because of the likely data and modeling inconsistencies between insurers. This alternative would also preclude other analytical processes, such as portfolio cash flow modeling that could be performed by the SVO.

This is an important first step in finding alternative ways to measure insurers' investment risk and reducing the NAIC reliance on rating agency ratings. Both alternatives will involve a commitment of resources either by the NAIC or industry. The major question before the Task Force is whether it has a preferred source for these market data fields; i.e., the NAIC's SVO or insurer reporting. The SVO believes that the first option would provide the most standardization in data and utility to state insurance regulators, the SVO, and other interested NAIC groups, and it would be worth the slightly longer time and cost needed to develop the capabilities.

If, as the SVO recommends, the Task Force prefers the SVO as the source of this analysis, then the next step recommended is a referral to the Financial Condition (E) Committee to request its sponsorship for this initiative and, if provided, begin a fiscal request. If the Committee declines to sponsor the initiative or if insurer reporting is the preferred source, the recommendation is to revert to insurer reporting and direct SVO staff to prepare the Blanks referral.

The SVO believes that the benefits to be gained by state insurance regulators, the SVO, and other NAIC groups with interests in investment risk of bringing this modelling capability in-house greatly outweigh, in the long run, the initial costs and effort to make these capabilities. However, it would require a substantial commitment of NAIC resources.

Ms. Mears said no recommendation is expected from the Task Force today, but rather continued discussion and exposure of the memo just detailed and an opportunity to provide direction at an upcoming meeting. As this is put out for exposure, the Task Force welcomes comments, as these are clearly two options that the staff has really laid out. Any other insights or nuanced response from industry as to the best way to be able to gather this information is welcome, along with an open dialog to find the best solution.

Mr. Anderson said the objectives stated here are certainly laudable. The question is whether it is time now to decide which data needs to be assembled to accomplish those objectives. First, NAIC designations today are the same as nationally recognized statistical rating organization (NRSRO) ratings as they relate to credit risk, ability, and willingness to pay on a scale of 1 to 20. What the staff memo talks about for the first time here is something that has been discussed as investment risk and now been renamed actual overall risk. Actual overall risk, which includes liquidity and any number of other elements, is interesting to state insurance regulators and important, but it is not part of today's structure. If there is a desire to broaden the notion of overall risk from today's structure, which is credit risk, or default risk, then tools need to be developed for state insurance regulators with them and their input in mind because it would be very unfortunate to develop a dashboard or something that is not useful at the examination level. Before a determination is made as to which data elements should be required, some work should be done on a workbench to see what kind of product can be developed using those inputs. It is not appropriate to use investment risk or actual overall risk to evaluate the performance of the rating agencies. The NRSROs are not looking at the overall investment risk; they are looking at what the NAIC looks at for C1 and R1, and that is default risk. RBC is presently structured to consider and measure default risk; then, within the structure, it deals with things like recovery, concentration, and other elements, but it would be inappropriate to use anything other than the present designation method, which is the same as rating agency metrics to judge a rating agency. There are other ways to judge a rating agency, and that is one of the things the Office of Credit Ratings (OCR) of the U.S. Securities and Exchange Commission (SEC) has offered up—the performance measurement data—which

is published in a uniform standard for NRSROs. There are other methods, but the idea of using something other than credit default metrics to evaluate the performance of a rating agency is inappropriate.

Ms. Mears said the intent to the newer option, where the SVO would produce the metrics, would be to implement more of a risk analytic system that has some flexibility, where the data fields do not need to be defined in advance. That is a downside of the Scheduled D proposal with insurers doing the reporting; it limits the data fields. State insurance regulators may discover over time that other measures of analytical risk are more appropriate. That is something to consider as well as these options are reviewed.

Mr. Therriault clarified that NAIC designations are not the same as a rating agency rating. The SVO does not hold itself out as a rating agency, and there should be no comparability or equivalency between the two. NAIC designations reflect the NAIC's financial solvency framework. It is very explicit in Part One of the P&P Manual, which contains the policies of the Task Force, as to what an NAIC designation is and what it is not.

Ms. Mears directed staff to expose the memo on alternatives to add fixed income analytical risk measures to investments reported on Schedule D, Part One for a 30-day public comment period ending Sept. 12.

9. Discussed, Received Comments, and Exposed a Revised Proposed Amendment to the P&P Manual to Update the Definition of Other Non-Payment Risk Assigned a Subscript "S"

Ms. Mears said the next item is to discuss and consider exposing an amendment to the P&P Manual to update the definition of Other Non-Payment Risk assigned a Subscript "S."

Mr. Perlman said at the 2021 Fall National Meeting, the Task Force exposed a proposed amendment, which was intended to clarify the meaning of Other Non-Payment Risk warranting a Subscript "S," with the inclusion of additional illustrations, and add such investments to the ineligible for FE list. At the Spring National Meeting, the SVO was directed to work with industry on technical modifications to this proposed amendment. The SVO met with representatives of the ACLI, the PPiA, and NASVA on April 29, May 6, May 24, and June 17. The revised amendment reflects items discussed during those meetings. However, there was not consensus on three primary issues, each a proposed illustration of an Other Non-Payment Risk warranting a Subscript "S": 1) maturities equal to or exceeding 40 years; 2) certain deferred principal payment features; and 3) certain deferred interest payment features.

The SVO recommends exposing the definitional updates to Part Two of the P&P Manual, which include the new illustrations, and deferring the proposed Part Three instructions to remove securities with Other Non-Payment Risks from FE. This deferral is intended to give industry sufficient time to provide examples of securities that are publicly rated by different CRPs, which have any of the three characteristics just listed for which there was not consensus, so the SVO can study them.

Ms. Mears said in prior conversations, there was a request from interested parties to just get some additional context on some of the reasoning behind why each of these were listed.

Ms. Mears directed staff to expose the revised proposed amendment to the P&P Manual to update the definition of Other Non-Payment Risk assigned a Subscript "S" for a 30-day public comment period ending Sept. 12.

10. Received Comments on IAO Issue Paper on the Risk Assessment of Structured Securities – CLOs

Ms. Mears said the next item is to receive comments on the IAO paper on the risk assessment of Structured Securities – Collateralized Loan Obligations (CLOs).

Jean-Baptiste Carelus (NAIC) said the SSG made two recommendations to the Task Force. The Task force should direct the modeling of CLOs by the NAIC and direct referrals to the Capital Adequacy (E) Task Force and the RBC Investment Risk and Evaluation (E) Working Group, requesting that those groups consider creating or breaking out the NAIC 6 Designation into three designation categories; i.e., 6.A, 6.B, and 6.C. The rationale for the recommendation is that the aggregate RBC factor for owning all the CLO tranches should be the same as required for owning all the underlying loan collateral. This would eliminate RBC arbitrage that currently exists. The modeling would be based on the current CLO stress tests. The methodology for the stress tests is available on the NAIC website under the Resource Center in the Capital Markets section. Currently, the scenarios and probabilities have not been set, and the SSG will come up with eight to 12 scenarios. The scenarios will probably be various combinations of default rates and recovery stresses.

The Task Force exposed the IAO's memo with the recommendation from staff, and there were several comments received. Most of the comments were supportive but cautious, and others were concerned, especially about the implication of the recommendation. The SSG grouped the responses into four categories: timing, policy arguments, transparency, and methodology. Under the timing, respondents were concerned that the recommendation would be implemented immediately. To alleviate that concern, the SSG estimated a timeline. In that timeline, the exposure for comments on the proposed P&P Manual amendment would be late 2022. The development and refinement of methodology, excluding the scenarios, would be about late 2022 as well, but going most likely into mid-2023. Then there is the development of scenarios, probabilities, and the RBC tie out. SSG staff estimate that that would also be in 2023, and the process itself would most be the most collaborative and interactive step in the process. The final implementation, which at the earliest is estimated to be about year-end 2023, will possibly be pushed into year-end 2024.

The NAIC process in moving this proposal forward will be collaborative and provide many opportunities for comment from interested parties. The next category of comments is policy arguments. Respondents emphasized the importance of the CLOs to the U.S. capital markets and the historical performance of the asset class. State insurance regulators and staff appreciate and understand the role of insurers and their investments in the U.S. economy and the financial markets. The main priority of state insurance regulators is policyholders and ensuring their protection through prudent financial solvency policies.

As for performance, the historical performance of CLOs has been good; this is especially true for the top of the capital stack. The recommended action is designed to allow insurers to continue participating in the CLO market without the risk that aggressive structuring puts policyholders and the investments in jeopardy. Given the performance of CLOs, some respondents commented that staff have not justified RBC at the 75% and 100% level. The current system works well if the intrinsic price is 70 or above since the highest RBC is currently 30%. A good example comes from the 2008 financial crisis, where a mezzanine residential mortgage-backed securities (RMBS) tranche was evaluated with an intrinsic price of 5. The resulting RBC was far below the risk evaluated. This may also occur in the residual tranches, such as CLO equity, if cash flows are interrupted to protect senior tranches. There will be plenty of opportunity for commenting about modeling, and there will be plenty of opportunities to discuss the comments related to modeling, transparency, and methodology.

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As this process moves forward into modeling, the SSG will expose all proposals with sufficient time for comment and feedback. Staff recommends that the Task Force proceed with the proposal, specifically referring the RBC issue to the RBC Investment Risk and Evaluation (E) Working Group and directing staff to draft P&P Manual language for exposure and direct staff to work with interested parties to fine tune methodology and draw up scenarios and probabilities.

There are three main questions that have been encountered within interactions and comments about this. The first question is whether this is applicable to other structured assets if there are many structured assets. This proposal from staff is purely related to CLOs in terms of risk arbitrage. The recommendation in terms of internal modeling is solely for that purpose. The second question is whether there is sufficient staff and expertise because the work is overwhelming. The SSG has been doing this modeling since 2018 when the first CLO stress test was conducted. Given that this will now be formally put into policy, it will be much easier when the process is deliberately staffed and funded. The final question is how it will work and whether insurers will need to look up a table or database to recognize the arbitrage adjustment. It will work the same way it currently works for RMBS. The insurer would go to the website for the AVS+; download the designation or break points, as appropriate; and determine how to report their tranche.

Ms. Mears said while the modeling itself is a distinct effort from the SVO and the SSG under the Task Force and the creation of RBC would fall to the RBC groups, the Task Force recognizes that the efforts need to be coordinated, and it anticipates ongoing workstreams with constant touch points, as was hopefully reiterated several times. This is meant to be a very transparent process. This initial proposal or exposure was to give the “heads up” that the Task Force is looking at this and to get some initial feedback and start this process. There were some interested parties that thought this was it and that was everything they were going to see. That was certainly not the intent. This will be very deliberative and transparent as the Task Force moves through this process. There will be several points for discussion, exposure, and comment, including starting with the methodologies and moving on to scenarios and probabilities. The RBC groups will have their own timeline as well for looking at potential factors. The Task Force will be referring an issue to the RBC groups, which is the concept that perhaps additional granularity within the NAIC 6 category may be necessary to accurately capture the risk associated with residual tranches. In the Task Force’s recommendation, it suggests that charges higher than 30% are needed. That is something that clearly the RBC groups will look at and decide how to implement. This is expected to be a very interactive process, potentially with multiple iterations in some of these workstreams, and encourage the open dialog that has already occurred with interested parties that want to know what is going to happen and to continue that dialog with those parties.

Ms. Mears said comment letters were received from the American Investment Council (AIC), Athene, Egan-Jones Ratings Company, the Loan Syndications and Trading Association (LSTA), PineBridge Investments, the Structured Finance Association, the Teachers Insurance and Annuity Association of America (TIAA), and the ACLI.

Steven Clayburn (ACLI) said it struck him that there is an issue paper on the stress methodology. The ACLI asked if there will be time to allow for an exposure of that issue paper since it was unaware of that paper or any discussion when the stress testing was done. This would give time to see if the modeling has similarities to what was done for the C1 bond factors that went to the expansion of 20 pieces. The ACLI asked if there would also be an opportunity to have the SSG’s comment letter response exposed so further comments could be provided.

Mr. Carelus said the methodology paper for the CLO stress test was first published back in 2018 after the first time the stress was run. The SSG has run it every year since 2019 and 2020. The CLO stress test methodology paper is

available on the NAIC website, under the Resource Center in the Capital Markets Bureau section. Ms. Mears said the CLO stress test methodology will be exposed with the materials on the Task Force web page.

Rebekah Goshorn Jurata (AIC) said the AIC is an advocacy and research organization that represents the leading PE and credit firms around the world. The AIC has a lot of experience with the investment needs of insurers, as well as the customers of the insurance companies. The AIC has a vested interest in the important work of the Task Force and welcomes the continued engagement and exposure of these materials.

Ms. Mears directed staff to expose the presentation along with the existing methodology paper for a 30-day public comment period ending Sept. 12 and prepare a proposed P&P Manual amendment that would assign the responsibility for assigning NAIC designation for CLOs to the SSG. This proposed amendment will be discussed at a future meeting and publicly exposed for comment. Ms. Mears directed staff to prepare papers for eventual exposure of the proposed CLO methodology, scenarios, and probabilities. As mentioned earlier, each of these will be exposed for public comment, and there will be an opportunity for informal dialog in between exposures to help inform what the initial exposure will look like. Ms. Mears also directed staff to prepare a referral to the Capital Adequacy (E) Task Force and the RBC Investment Risk and Evaluation (E) Working Group requesting them to contemporaneously consider the recommended additional NAIC Designation Categories and RBC factors for the residual tranche while this Task Force continues with its work on assessing the investment risk and assigning NAIC designations to CLOs.

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

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

Julie Gann (NAIC) said the principles bond project, the definition issue paper, and actual statutory revisions to *Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds* and *SSAP No. 43R—Loan-Backed and Structured Securities* is exposed on the Working Group web page.

12. <u>Heard a Staff Update on the Ad Hoc CRP Study Group</u>

Ms. Mears said the next item is to hear a staff update on the Ad Hoc Study Group. The ad hoc group continues to meet and does not have any deliverables at this point, but it does expect to move forward with conversations with CRPs later and will keep the Task Force informed once there is something to propose.

13. <u>Received an Update from the SSG on Modeling Scenarios</u>

Ms. Mears said the next item is to hear a staff update from the SSG on modeling scenarios.

Mr. Therriault said he would go through the macroeconomic scenarios and probability assignments that the SSG is planning. If there are any specific technical questions, he recommended emailing them to the SSG.

The commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS) scenarios were previously presented at the June 9 Task Force meeting. Additional macroeconomic scenarios are being added to better differentiate the risk across the 20 NAIC Designation Categories. This is an expansion from the current four scenarios to a total of eight for RMBS and CMBS. Probability weights have been assigned to each scenario,

with a reallocation of probability weights with lower probabilities at the tail and increased aggregate probabilities at the belly of the distribution.

The new distribution now has a more typical bell shape of the range of macroeconomic scenarios for both RMBS and CMBS. The new scenarios are presented in bold for CMBS and RMBS in tabular and graphical form.

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

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