VALUATION OF SECURITIES (E) TASK FORCE

Valuation of Securities (E) Task Force 2021 Summer National Meeting Minutes (Attachment One)
Valuation of Securities (E) Task Force September 30, 2021, interim minutes (Attachment Two)
Valuation of Securities (E) Task Force November 17, 2021, interim minutes (Attachment Three)

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Valuation of Securities (E) Task Force
2021 Fall National Meeting
December 12, 2021

The Valuation of Securities (E) Task Force met Dec. 12, 2021. The following Task Force members participated: Dana Popish Severinghaus, Chair, represented by Kevin Fry (IL); Doug Ommen, Vice Chair, represented by Carrie Mears (IA); Lori K. Wing-Heier represented by David Phifer (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kathy Belfi and Ken Cotrone (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Ray Spudeck and 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); Kathleen A. Birrane represented by Matt Kozak (MD); Gary D. Anderson represented by John A. Turchi (MA); Chlora Lindley-Myers represented by Debbie Doggett (MO); Eric Dunning represented by Lindsay Crawford and Justin Schrader (NE); Marlene Caride represented by John Sirovetz (NJ); Russell Toal represented by Lea Geckler (NM); Adrienne A. Harris represented by Jim Everett (NY); Cassie Brown represented by Jamie Walker (TX); Jonathan T. Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte and Greg Chew (VA); Mike Kreidler represented by Tim Hays (WA); and Mark Afable represented by Amy Malm (WI).

1. Adopted its 2021 Summer National Meeting, Sep. 30 and Nov. 17 minutes

Mr. Fry said the first item on our agenda is to consider the adoption of the minutes from the Summer National Meeting, and the Sep. 30 and Nov. 17 interim meeting conference calls.

Ms. Belfi made a motion, seconded by Ms. Walker, to adopt the Task Force's 2021 Summer National Meeting, Sep. 30, and Nov. 17 minutes. The motion passed unanimously.

2. Adopted amendment to the P&P Manual to remove residual tranches from receiving an NAIC Designation

Mr. Fry said our next agenda item is to discuss and consider adoption of a proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis* Office (P&P Manual) to remove residual tranches from receiving an NAIC Designation. Residual tranches capture securitization tranches and beneficial interests that reflect loss layers without any contractual payment of principal or interest. Instead, residual tranches are paid after contractual payments of principal or interest have been made to other tranches and are based on the remaining available funds.

Charles Therriault (NAIC) said the Statutory Accounting Principles (E) Working Group identified inconsistencies in how residual tranches and interests were being reported, with some entities reporting them on Schedule BA: Other Long Term Invested Assets and others reporting them on Schedule D-1: Long-Term Bonds with either self-assigned NAIC 5GI or NAIC 6 Designations. To prevent further inconsistency and direct appropriate reporting, on Nov. 10, the Working Group adopted an amendment to *SSAP 43R – Loan Backed and Structured Securities* to clarify that residual tranches and interests shall be report on Schedule BA. To accommodate the timeframe needed for a Blanks (E) Working Group proposal to expand reporting lines on Schedule BA to capture residual tranches and interests, the Working Group's amendment permits residual tranches and interests currently reported on Schedule D-1 to continue to be reported on Schedule D-1 for 2021 reporting with an ultimate effective date of December 31, 2022.

The SVO staff agree with the Working Groups recommendation that during this window when residual tranches currently reported on Schedule D-1 are permitted to stay on Schedule D-1, they should be allowed to do so only with an NAIC 6* Designation and not an NAIC 5GI Designation. This is consistent with the Working Group's adopted change. The NAIC 5GI Designation is not appropriate for residual tranches and interests because according to the P&P Manual, "an insurance company is permitted to self-assign an NAIC 5GI to an obligation if it meets all of the following criteria:

1. Documentation necessary to permit a full credit analysis of the security by the SVO does not exist or an NAIC CRP rating for an FE or PL security is not available.
2. The issuer or obligor is current on all contracted interest and principal payments.
3. The insurer has an actual expectation of ultimate payment of all contracted interest and principal.

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Assignment of an NAIC 5GI Designation for residual investments is an incorrect application of the guidance as: there are no contracted interest and principal payments to certify as current and the insurer cannot have an actual expectation of receiving all contractual principal and interest of the underlying collateral as these tranches absorb the losses first for the securitization structure. Although cash flows may pass through to the residual holders at periodic intervals under the waterfall, ultimate returns depend on continued performance so, therefore, there can be no actual expectation that future payments will be received.

Along with the proposed P&P Manual language requiring residuals to be reported on Schedule BA, there is a proposed provision stating that for 2021 year-end reporting residuals will be permitted on Schedule D-1 with an NAIC 6. If adopted, the SVO requests the Task Force's permission to remove that provision from the 2022 version of the P&P Manual, without further authorization.

There were other requests from the Working Group related to NAIC 5GI and 6 that the SVO would like to bring up with the Task Force next year. The SVO staff recommends adoption of this amendment today.

Mr. Kozak made a motion, seconded by Mr. Chew, to adopt the amendment to the P&P Manual to clarify proper reporting and designation for residual tranches and interests. The motion passed unanimously.

3. <u>Adopted amendment to P&P Manual to Clarify 5GI Mapping to NAIC Designation Category</u>

Mr. Fry said the next item is to discuss and consider adoption of a technical correction amendment to the P&P Manual clarifying 5GI mapping to a Designation Category in the recently amended Private Letter Rating section.

Marc Perlman (NAIC) said at the May 24 meeting the Task Force adopted an amendment to the P&P Manual requiring the submission of Private Rating Letter Rationale Reports with certain Private Rating Letters filed with the SVO. In the May amendment certain language, which is currently in the printed December 2020 version of the P&P, which clarifies that an NAIC 5GI Designation is the equivalent of an NAIC 5.B Designation Category, was mistakenly omitted. The SVO proposes a non-substantive technical amendment to the May amendment to reinsert the omitted language.

Ms. Doggett made a motion, seconded by Ms. Clements, to adopt this amendment to the P&P Manual to clarify the mapping of NAIC 5GI to a Designation Category. The motion passed unanimously.

4. <u>Exposed amendment to the P&P Manual to update the definition of Other Non-Payment Risk assigned a Subscript "S"</u>

Mr. Fry said the next agenda item is to discuss and consider exposure of a proposed amendment to the P&P Manual to update the Definition of Other Non-Payment Risks Assigned a Subscript "S".

Charles Therriault (NAIC) said securities that possess "Other Non-Payment Risks" are intended to be reviewed by the SVO but these investments have not been explicitly included on the list of Specific Populations of Securities Not Eligible For Filing Exemption in Part Three of the P&P Manual. Securities with other non-payment risks are identified through assignment of the Administrative Symbol "S" as a subscript to the NAIC Designation. This amendment would add "Securities with Other Non-Payment Risks" to the list of securities that are ineligible for filing exemption.

As noted in Part One, paragraph 90, of the P&P Manual, "*An objective of the VOS/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. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is required to identify securities that contain such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer, so this can be reflected in the NAIC Designation assigned to the security through the application of the notching process.*"

The proposed amendment would further clarify through additional illustrations securities that would also be considered as having "Other Non-Payment Risks". These would include securities that:

a) incorporate the performance of other assets to determine their contractual payments, either directly or indirectly through reference pools, equity baskets, or indices.

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b) receive payments as the remainder or residual cashflow after all other payment obligations have been made.
c) receive additional performance or bonus cashflows; or have no contractual events of payment default.

Mr. Fry said this amendment enhances the guidance around the subscript "S" and does not change policy in any way but makes it clearer with additional examples.

Mr. Fry directed the SVO to expose the proposed amendment to the P&P Manual to update the definition of Other Non-Payment Risks Assigned a Subscript "S" for a 60-day public comment period ending Friday, Feb. 11, 2022.

5. <u>Exposed amendment to the P&P Manual to update the definition of Principal Protected Securities (PPS)</u>

Mr. Fry said next is to discuss and consider exposure of a proposed amendment to the P&P Manual to update definition of principal protected securities. In May of last year, the Task Force adopted an amendment to the P&P defining principal protected securities and making them ineligible for Filing Exemption. The SVO has seen new transactions with similar risks, but which do not precisely fit the current definition.

Marc Perlman (NAIC) said last May the Task Force adopted an amendment to the P&P to include principal protected securities (or PPS) as a new security type ineligible for the filing exempt process. At the time, the types of PPS which the SVO had seen were mixes of a traditional bond or bonds with additional assets that could possess any characteristic. These additional assets, which the SVO called "performance assets," were intended to generate excess return. They included, among other things, derivatives, common stock, commodities and equity indices. The performance assets often included undisclosed assets and were typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond. In each case, the external credit rating was based solely on the component dedicated to the repayment of principal and ignored the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1

Recently, the SVO received a proposal for a security which poses many of the same risks as a PPS but was structured in a way that it did not cleanly fit the definition in the P&P. In this example, the security was not issued by an special purpose vehicle (SPV) holding an "underlying" principal protection bond and the performance asset. "Underlying" is a key component of the current definition. Rather, the security was the direct obligation of a large financial institution whose obligation it was to pay principal at maturity and a premium based on the performance of referenced indices, including an equity index and an index comprised of equities, fixed-income instruments, futures and other financial assets. Though the obligation was solely that of the issuing financial institution, meaning there were no <u>underlying</u> bonds or performance assets, the structure posed the same risk of exposure to a performance asset because the amount of the issuer's payment obligation was directly dependent on the performance of the referenced indices. Additionally, unlike a PPS transaction with an underlying bond and performance asset, the likelihood of payment of that performance asset premium, whatever the amount might be, was linked directly to the creditworthiness of the issuer. As such, the SVO proposes amending the P&P Manual definition of Principal Protected Securities to account for alternate structures which pose similar risks.

Mr. Fry said the objective of this amendment is to take the PPS methodology and expanded it to include these newer securities. Mr. Fry directed the SVO to expose this proposed amendment to the P&P Manual to update the definition of Principal Protected Security for a 60-day public comment period ending, Friday, Feb. 11, 2021.

6. <u>Exposed amendment to the P&P Manual to assign NAIC Designations to investments with a Fixed Income component for reporting on Schedule BA</u>

Mr. Fry said next is to discuss and consider exposure of a proposed amendment to the P&P Manual to add guidance on the designation of Schedule BA assets with fixed income characteristics. There are potentially many securities which do not qualify as bonds for purposes of reporting on Schedule D-1 but which have fixed income characteristics. If it were possible to assign a designation to these investments, they could potentially benefit from more favorable RBC treatment on Schedule BA.

Marc Perlman (NAIC) said the SVO recommends updating the instructions in Part Three of the P&P Manual to include guidance related to the assignment of NAIC Designations to Schedule BA assets with underlying characteristics of bonds or fixed income instruments. Part One of the P&P Manaul currently permits the SVO to assign NAIC Designations to Schedule BA assets with underlying characteristics of bonds or fixed income instruments, but there is currently no specific guidance for the SVO in Part Three. Including the proposed provisions would enable the SVO to assign NAIC Designations to Schedule BA assets which are not expressly covered by other sections of the P&P Manual (such as Schedule BA Funds). Schedule BA

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assets for life and fraternal insurers would benefit from NAIC Designations because they would be eligible for more favorable RBC treatment.

The SVO's authority to assign NAIC Designations to certain Schedule BA assets already exists. Part One of P&P Manual states that, "The SVO is assigned to assess investment securities reported to state regulators on Schedule D and Schedule BA.". Additionally, the P&P explains that to be eligible for the assignment of an NAIC Designation a Schedule BA asset must have underlying characteristics of a bond or fixed income instrument. This proposed amendment would potentially make various types of assets eligible for an NAIC Designation which currently are not. Each asset would need to be individually assessed by the SVO for bond or fixed income characteristics.

Mr. Fry said this issue has been around for a while where on Schedule BA a fixed income like investment receives an NAIC designation from the SVO for a life or fraternal insurer but a property and casualty insurer would not receive that same risk-based capital (RBC) treatment. There are a lot of asset classes that maybe are not specifically designed as a bond but the SVO could assign a designation to it. Thinking forward with the bond project, if any assets fall off schedule D-1, this would at least give it a potential home if they can satisfy the requirements of the SVO with the designation

Mr. Fry directed the SVO to expose this proposed amendment to the P&P Manual to add guidance on the designation of Schedule BA assets with fixed income characteristics for a 60-day public comment period ending, Friday, Feb. 11, 2021.

7. <u>Exposed amendment to the P&P Manual to permit the SVO to assign NAIC Designations to unrated subsidiaries of in WCFI transactions</u>

Mr. Fry said the next item on the agenda is to discuss and consider exposure of a proposed amendment to the P&P Manual to permit the SVO to Assign NAIC Designations to unrated subsidiaries in Working Capital Finance Investment (WCFI) transactions. The Task Force has gone through several iterations of this amendment over the past year. In this latest version the SVO is reintroducing a proposal under which the Task Force would give the SVO discretion to notch down from the parent's rating in certain circumstances. It adheres very closely to an earlier version of the proposal.

Marc Perlman (NAIC) said the SVO received comments from certain insurers and other interested parties that it should assign NAIC Designations to WCFIs with unguaranteed and unrated obligors, based on the implied support from an obligor's NAIC Credit Rating Provider rated parent.

In November 2020, the Task Force exposed a proposed amendment to the P&P Manual to direct the SVO to rely upon the NAIC Designation or NAIC CRP Rating equivalent of the subsidiary obligor's parent entity, with allowance for the SVO to notch down from the parent's rating or NAIC Designation due to its assessment of certain factors regarding the parent/subsidiary relationship. In response to feedback from some Task Force members and interested parties, the SVO subsequently presented a revised proposal to the Task Force at the Summer 2021 National Meeting to remove its discretion to notch because, as demonstrated in our memorandum to the Task Force of Oct. 16 of last year, the SVO found no generally accepted analytical technique or methodology to support the assumption that a parent entity will necessarily support its subsidiary in times of financial distress. That revised amendment was also not adopted by the Task Force.

The SVO is now proposing a new clean amendment which is substantially similar to the original and reflects the comments from some Task Force and Statutory Accounting Principles (E) Working Group members that they would like the SVO to retain discretion to notch down, as it deems appropriate. Like the November 2020 amendment, the Task Force would direct the SVO to imply the parent's support of its subsidiary and would give the SVO discretion to assign an NAIC Designation to the subsidiary which is lower than that of the parent based on its assessment of the parent/subsidiary relationship. However, this new proposal clarifies that if the SVO notches the NAIC Designation of a subsidiary obligor down from that of its parent resulting in a credit assessment below an NAIC 2, the WCFI program would not be eligible for an NAIC Designation because it would no longer meet the definition of an eligible "Obligor" in SSAP 105R – Working Capital Finance Investments.

Mr. Fry said one thing that is important to regulators is that the Task Force created a framework for working capital finance investments and put a lot of guardrails around them. This is one of the reasons why the Task Force got comfortable with this asset class. Some these subsidiaries that issue the working capital finance notes do not have a rating but are consolidated into a larger group and a top entity is rated. There are a lot of interconnectedness and relationships between those entities short of a full guarantee of it, but it has a place in the structure. In those cases, the Task Force could use this policy to just use the top rating. If the SVO saw something abnormal or something that was a little out of place from that what would be normally seen,

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the SVO could notch. If it does not pass the NAIC smell test for any reasons, the SVO can notch it down. If it falls below investment grade it will not even be allowed to be admitted. It will make a lot of sense for the Task Force, if it decides to go with this policy, to monitor the activity and what the transaction looking like. If there was anything about them that is concerning, the policy could always be adjusted. The Financial Accounting Standards Board (FASB) and U.S. Securities Exchange Commission (SEC) are looking at these investments too. FASB is looking at possibly creating new disclosure requirements.

Mr. Fry directed the SVO to expose this proposed amendment to the P&P Manual to assign NAIC Designations to unrated subsidiaries in Working Capital Finance Investment transactions for a 60-day public comment period ending Friday, Feb. 11, 2021.

8. Heard a Staff Report on Use of NAIC Designations by Other Jurisdictions in the Regulation of Insurers

Mr. Fry said the next item is to discuss a recent request that the SVO received related to non-U.S. jurisdictions wishing to reference NAIC Designations.

Charles Therriault (NAIC) said the SVO was made aware of regulators or insurers in non-U.S. jurisdictions, such as the Bermuda Monetary Authority and Japan's Financial Services Agency, either referencing NAIC Designations in their regulatory processes or wanting to reference them. The P&P Manual is very specific that NAIC Designations are only intended for NAIC members consisting of the chief insurance regulators of the 50 states, the District of Columbia and five U.S. territories. For example, the P&P says of the intended, proper and authorized use of NAIC Designations is the following:

1. An NAIC designation for quality (NAIC Designation) of a security is produced solely for NAIC members who should interpret the designation for quality, in the context of the NAIC Financial Regulation Standards and Accreditation Program, a member's state insurance laws and regulations, and the regulatory or financial solvency profile of a specific insurance company.
2. Because an NAIC Designation, is not produced to aid the investment decision-making process, NAIC Designations are not deemed to be suitable for use by anyone but NAIC members.
3. NAIC Designations are not intended to be and should not be used as if they were the functional equivalent of the credit ratings of nationally recognized statistical rating organizations or other rating organizations whose ratings are intended to be used by investors as predictive opinions of default risk.
4. The use or adoption of NAIC Designations by anyone other than NAIC members is improper and is not authorized by the NAIC, and
5. NAIC Designations and other analytical products of the SVO and SSG are produced solely for the benefit of NAIC members in their capacity as state insurance department officials for use in the NAIC Financial Regulation Standards and Accreditation Program.

If, despite the noted restrictions on the use of NAIC Designations, NAIC members consider it worthwhile to have the ability to approve the use of NAIC Designations by the insurance regulators of certain non-member jurisdictions, the SVO would recommend certain conditions to be met. These conditions would include acknowledgement by the requesting regulator in a memo of understanding (i) of the intended purposes of NAIC Designations (including that NAIC Designations are not the functional equivalent of credit ratings), and (ii) that the requesting regulator's uses may deviate from the NAIC's intended purposes. Additionally, a formal process would need to be created, involving necessary amendments to the P&P Manual, to authorize and rescind authorization of the requesting jurisdiction. Consideration of the jurisdiction's recognition by the Mutual Recognition of Jurisdictions (E) Working Group could be another requirement of authorization. Once authorized and listed in the P&P Manual, insurers in that jurisdiction could then be given access to the SVO List of Investment Securities compiled in AVS+ and be permitted to file securities with the SVO. The SVO is issuing this report just to request guidance from the Task Force on how to proceed forward.

Mr. Fry said as a regulator over the years, there are certain jurisdictions, i.e. Cayman, if you form an insurer or reinsurer there, it can also select the accounting methodology to use there, the U.S. RBC system is an option. And in that case, regulators are very comfortable with that as the ratings are understand and how they are used. In that context, it would seem useful. It is important to acknowledge that NAIC designations are produced for NAIC members and intended for NAIC regulatory purposes. From a legal perspective, it would be important to be upfront with the limitations of NAIC designations. Before pursuing all that, this is letting the Task Force know it is something being considered. If there are no concerns, the SVO staff

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will proceed along these lines of developing some guidance that would clarify the issues. Task Force member can reach out to the SVO staff if they have any comments. No action is needed at this time other than soliciting input from the Task Force.

9. Heard a Staff Report on Rating Issues and Proposed Changes to the Filing Exemption Process

Mr. Fry said the next item is to hear a report from the Investment Analysis Office on issues they are seeing with the NAIC's use of ratings. This issue has been before the Task Force several times, most recently it was discussed at the Task Force's Educational Session this October during a confidential session. The themes in this memo echo the findings of the Rating Agency Working Group that was formed to study the NAIC's reliance on rating agencies after the Financial Crisis in 2008. The Working Group's recommendation were adopted by the NAIC in 2010 and it may be time for the Task Force to refresh themselves on these adopted items.

Charles Therriault (NAIC) said the SVO, Structured Securities Group (SSG) and Capital Markets Bureau (CMB) staff have raised our concerns about the NAIC's reliance on rating agency ratings several times. The SVO staff have twice before analyzed cross rating agency rating differences and the results of this most recent analysis is consistent with the prior reviews. As was requested by the Task Force last year when it was discussing private letter rating rationale reports, the SVO provided the Task Force with an in-depth review into some of the specific issues and inconsistencies it is seeing. The SVO walked the Task Force through 43 different privately rated securities that had risk assessments that were materially different that the SVO staff's assessment, material being 3-6+ rating notches higher or 1-2 full ratings categories higher. This was not intended to be an exhaustive audit of all privately rated securities was only highlighting to the Task Force that there are meaningful deviations that SVO is seeing in risk assessment that can result in inappropriately low Risk Based Capital (RBC) for very risky assets.

The NAIC relies heavily on credit rating providers to assess the risk for the vast majoring of insurer investments. This reliance comes with no oversight as to the analytical basis for those ratings, the applicability or strength of the methodology, or the consistency of the resulting risk assessments. The SVO is not charged with monitoring credit rating providers or authorized to use its judgement or discretion to determine how, when and if a CRP rating should be used for NAIC purposes. Quoting from some of the Rating Agency (E) Working Groups recommendations from 2010:

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

"ARO (we now call them credit rating providers or CRPs) ratings have a role in regulation; however, since the ratings cannot be used to measure all the risk that a single investment or a mix of investments may represent in an insurer's portfolio, NAIC policy on the use of ARO ratings should be highly selective and incorporate both supplemental and alternative risk assessment benchmarks."

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

"Consideration should be given to modifying the filing exempt rule to adjust for securities with new additional ARO ratings and other measures (such as V Scores and Parameter Sensitivities) when deemed applicable. The need for difference RBC and/or some other and additional regulatory process should be evaluated. Such processes could include the use of market information on price direction and of yield trends in addition to ARO ratings for some or all filing exempt securities. Securities highlighted by this process can be reviewed by the SVO with the objective of adjusting the ARO rating to help ensure an accurate RBC charge."

The Working Group's recommendations are matched by staff's concerns today, that CRP rating does not reflect a reasonable assessment of a security's risk and the validity of the resulting RBC ratio, that relies upon that CRP rating to determine the factor to apply to that security, may be significantly compromised.

Marc Perlman (NAIC) said a common misconception about SEC oversight of rating agencies. Many people think that the SEC's recognition of a rating agency as an NRSRO means that the SEC has reviewed and approved of that rating agency's criteria and methodologies. That is not the case. NRSROs are regulated by the SEC, but under the Credit Rating Agency Reform Act of 2006, (which introduced Section 15 of the Securities Exchange Act) the SEC and States are forbidden from regulating NRSRO methodologies. The SEC cannot approve of or regulate the substance of a rating agency's methodologies.

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It cannot opine on the quality of a methodology. The SEC can enforce adherence to the process by which those methodologies were created and are applied.

The purpose of rating agency regulation is to improve ratings quality through transparency and competition. It's not to create uniform rating agencies with fungible methodologies and ratings but rather to expose the differences between the agencies. Like other federal approaches to securities regulation, NRSRO regulation focuses on accurate disclosure, allowing users of ratings, like the NAIC, to choose the NRSRO that best meets their needs.

Charles Therriault (NAIC) said in the attachment there are three different types of analysis comparing rating agency ratings, one looking the absolute values of rating notch differences between CRPs that rated the same security, the next cross-correlations between each CRP on securities rated by both and finally a principal component analysis that statistically portrays how alike or dissimilar each CRP is to one another. The identity of each rating agency was concealed to maintain confidentiality, but these charts show that there are significant differences between ratings agencies. Ratings are not fungible; a AAA is not a AAA no matter which CRP generates it. And because CRP assessments of risk are different, IAO staff believe, as did the Rating Agency (E) Working Group, that how each CRP's ratings are used in NAIC processes should also be different.

Eric Kolchinsky (NAIC) said some of the options that could be used for a better use of rating agency information are listed in the memo. The first option is to require at least two or sometimes more ratings for each security and then use the lowest of the two. If a security only has one rating, there is a process by which it is identified so that the SVO can look at the quality of that rating. Option two is a study, so this would look at the process by which the NAIC came up to the risk-based capital analysis. Those provide specific thresholds for each performance, rating, and the historical performance of each rating agency could be compared to those benchmarks, the thresholds. That is a lengthy process, but quite doable. Option three is something like what the NAIC does for RMBS and CMBS. The rating agencies are one of the few vendors that do not go through a RFQ or request for qualifications. Under this option they would be looked at like any other vendor and set up qualifications. The NAIC could look at that process of using that information at the NAIC and create a closer contractual relationship between the NAIC and rating agencies. Option four is for the Task Force to eliminate one or more rating agencies that could be done based on criteria, based on recommendations from a state or based on recommendations from another group such as the Financial Analysis (E) Working Group (FAWG). And lastly, a combination of one or more of these options as well, the options are not exclusive to one another.

Mr. Fry said the filing exempt (FE) process is something that Task Force has looked at a lot over the years. In 2004 the idea about letting companies self-designate was talked about but did not come to fruition. Rating agencies have been the NAIC's best option for RBC framework, leveraging off their credit ratings to turn them into a factor and that runs through RBC. The Task Force has seen some securities that do draw questions. This memo that was put out is a great starting point. There are a lot of questions that will be generated from this memo and a lot of people would like to understand the sample better and understand some of the statistics behind it. This document best purpose will be a starting point of discussion for the Task Force. One approach could be as Task Force goes into next year, form a smaller group of regulators, industry participants, and rating agencies, in a regulator only setting. This document could be used and gather everyone else's ideas because feedback is needed. Something needs to be done with FE, like anything else, it needs to be enhanced over time and doing what it's supposed to do. The SVO and regulators do not want to go fast and cause market turmoil and uncertainty. This must be a careful and collaborative approach.

Ms. Mears said she supports the idea of moving forward with a small study group that includes industry and has seen the benefits of that in other Working Groups and Task Forces. That collaboration between regulators, industry, other potential interested parties, and stakeholders can result in a proposal here that makes a lot of sense and addresses the core issues that has been seen. She appreciates the work that the SVO has done to bring these issue to light and agrees that it should be a priority next year.

Mr. Schrader said there are a number of different asset classes that are rated. The Task Force needs to look holistically at some rating agencies that have different methodologies and different types of classes. Is very important to make sure the regulators who are relying upon this understand what they are relying upon. If there are issues or concerns, the states have the authority to take action within their statute. It is most important to be consistent and hold the entire industry to the same standard. As Ms. Mears and Mr. Fry mentioned, to give the industry some certainty that when they invest in an asset, they sort of know upfront have a reasonable assumption of what the effects may be.

Mr. Fry received the report to use it as a basis for beginning discussions in 2022 and encouraged feedback.

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10. <u>Heard a Staff Report on Project of the Statutory Accounting Principles (E) Working Group</u>

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

Julie Gann (NAIC) said this report is just more of the coordination initiative to identify key items that the Working Group addressed to this Task Force as well. The Working Group met Saturday, Dec. 12th with a full agenda and addressed several items.

With regards to adopted items, the first is related to credit tenant loans. The Working Group adopted revisions to *SSAP No. 43R – Loan-Backed and Structured Securities* to explicitly identify the SVO identified credit tenant loans in scope. It is the final step with the credit tenant loan discussions over the last couple of years. With that adoption, examples from paragraph 27 were removed, which is not a scope paragraph, from the contents of the statements of statutory accounting principles (SSAP). The Working Group also explicitly notified the INT on credit tenant loans, which is 20-10 and had already expired. The Working Group wanted to identify the revisions that were adopted by the Task Force and the action by the Working Group was explicitly noted for historical purposes. The Working Group disposed the agenda item that had been drafted for credit tenant loans as it was no longer necessary.

The Working Group also adopted an agenda item indicating support for enhanced reporting of Federal Home Loan Bank borrowings in Exhibit 7 when they are structured as deposit type contracts. There were no statutory accounting revisions for that item but it is support for a blanks proposal which is currently out there. It will be in effect for 2022, not for this year end. There was some regulator feedback wanting to have those breakouts on Exhibit 7 as to where the Federal Home Loan Bank borrowings were captured. These change will have a 2022 effective date.

With regards to exposures, first, the Working Group exposed revisions to *SSAP No. 25 – Affiliates and Other Related Parties* and *SSAP No. 43R* to improve the reporting of related party investments. This agenda item does two things. First, it clarifies the reporting of affiliated investments in accordance with the existing definition of an affiliate that is in the model law, *SSAP No. 25* and *SSAP No. 97 – Investments in Subsidiary, Controlled and Affiliated Entities*. The Working Group is trying not to conflict with that existing definition, but what it also does is it proposes new reporting of related party investments through an electronic column in the investment schedule that would encompass all investments that are reported on the investment schedules. The goal there is to identify the involvement of related parties with regards to investments held. A key element has to do with if the related party is an originator or a sponsor of an investment, but the investment may not reflect an investment in the related party, per se. That is currently exposed for comment. It is also going to have a blanks proposal with an anticipated effective date of 2022, and it is anticipated that the blanks proposal will be exposed by the end of the year, if not early January.

The Working Group also exposed revisions to SSAP No. 43R are to reflect adopted changes from this Task Force as it pertains to the NAIC designation and the designation category for RMBS/CMBS under the financial modeling procedure. This has two options in the exposure. The first one is to reflect the revisions that were adopted by this Task Force in the SSAP No. 43R. The second option is to remove all that guidance from SSAP No. 43R and instead refer to the P&P Manual for guidance. And if you go back in time, that was the original process for those designations. In 2008, in response to the financial crisis and when the financial modeling was created, the Working Group pulled that guidance into SSAP No. 43R. The question is being asked if there is a need to continue that guidance in the SSAP or just refer to the P&P Manual. The Working Group would like feedback from the Task Force and industry with regards to those two options.

With regards to the bond proposal project, two items were exposed. The first is a reporting option discussion draft that presents different options for changes on Schedule D-1. This is a sizable change that is being considered for reporting on Schedule D-1, and the full intent is to have improved granularity and transparency on the investments that are being reported. In addition to reporting lines for the types of investments. It also asks questions on the current columns are captured, such as the code column, the collateral type of column, the bond characteristic column and asks questions on what information is currently being utilized, what is beneficial, what should be added. There are a lot of questions in that discussion draft, so definitely looking for feedback from regulators and industry with regards to that. Also on the bond proposal project, the Working Group exposed tracked changes to the principal concepts for a credit enhancement which is a required component for classifying an investment as an asset backed security. Originally, the terminology was for it a sufficient credit enhancement, and that was revised to be a substantive credit enhancement to better reflect the principal intent of that guidance. That is reflected both in the principle-based bond definition guidance, as well as in the examples that go along with that principle-based bond definitions.

Draft Pending Adoption

The Working Group also exposed revisions to expand the information that is reported for subsidiary controlled and affiliated investments (SCA) on Schedule D-6-1. Those SCAs are filed with the NAIC and used to go to the New York office. Now they come to the Kansas City Office. NAIC staff have seen over time where there may be NAIC staff adjustments based on the guidance that is in SSAP No. 97 and those revisions are not reflected in the next year's report in Schedule D-6-1. It is a recurring issue with regards to the adjustments not being made. These enhancements to Schedule D-6-1 are also in the electronic columns, and they just identify the NAIC adjusted value from the prior year, as well as additional information on the filing information. It is easier for the regulators to see if there is a sizable difference from what the company reported to what the NAIC adjusted value was. The comment deadline for all these exposures is Feb. 18, 2022. There were two other exposures not discussed today that had an earlier comment deadline of Jan. 14. All the adoptions and exposures are on the SAPWG summary, which should be posted.

11. Any other matters

Charles Therriault (NAIC) said the licensing for AVS+ system, where the NAIC produces and publishes NAIC designations and prices, has now moved to a full calendar year for 2022. There was a transition period in 2021 where the fee was adjusted for the 11-month period last year. The licenses used to renew in January and now it will be for the full calendar year. The 2022 fee is a little different from 2021 because it represents a full year, whereas last year it was just the 11-month period.

Mr. Fry announced that Kathy Belfi and himself are retiring in 2022.

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/Meeting Minutes/VOSTF 12.12.2021 NM Minutes.docx

Draft: 7/28/2021

Valuation of Securities (E) Task Force
Virtual Meeting (*in lieu of meeting at the 2021 Summer National Meeting)*
July 15, 2021

The Valuation of Securities (E) Task Force met July 15, 2021. The following Task Force members participated: Dana Popish Severinghaus, Chair, represented by Kevin Fry (IL); Doug Ommen, Vice Chair, represented by Carrie Mears (IA); Lori K. Wing-Heier represented by Wally Thomas (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kathy Belfi (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Carolyn Morgan (FL); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Chut Tee (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); Marlene Caride represented by John Sirovetz (NJ); Linda A. Lacewell represented by Jim Everett (NY); Doug Slape represented by Amy Garcia (TX); Jonathan T. Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays (WA); and Mark Afable represented by Randy Milquet (WI).

1. Adopted its May 24 and Spring National Meeting Minutes

Mr. Fry said the Task Force met May 24 and took the following action: 1) discussed comments received and adopted proposed amendments to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) for the following: a) require the filing of private rating letter rationale reports; and b) permit filing exemption (FE) for credit tenant loan (CTL) and ground lease financing transactions; and 2) received and discussed the Securities Valuation Office (SVO) referral response to the Statutory Accounting Principles (E) Working Group on CTLs.

Mr. Thomas made a motion, seconded by Ms. Clements, to adopt the Task Force's May 24 (Attachment) and March 22 *(see NAIC Proceedings – Spring 2021, Valuation of Securities (E) Task Force)* minutes. The motion passed unanimously.

2. Adopted its 2022 Proposed Charges

Mr. Fry said the Task Force's 2022 proposed charges remain unchanged from 2021.

Ms. Doggett made a motion, seconded by Mr. Kozak, to adopt the Task Force's 2022 proposed charges (Attachment Three). The motion passed unanimously.

3. Adopted a P&P Manual Amendment to Add Additional Instructions to the Review of Funds

Mr. Fry said the next agenda item is to discuss and consider for adoption an amendment to the P&P Manual to add additional instructions to review of funds. The original amendment (Attachment Four-B) was received by the Task Force during the Spring National Meeting and exposed for a 45-day public comment period ending May 6. This updated amendment reflects technical comments and recommendations that were received from interested parties (Attachments Four-C, D and E). The revised amendment was received and approved for exposure through a Task Force e-vote on June 1 and exposed for a 30-day public comment period ending July 1. There was one supportive joint comment letter received on the updated amendment from the American Council of Life Insurers (ACLI), the North American Securities Valuation Association (NASVA), and the Private Placement Investors Association (PPiA).

Marc Perlman (NAIC) said the new proposal would adhere much more closely than the previous one to Rule 18f-4 under the U.S. Securities and Exchange Commission's (SEC) Investment Company Act of 1940 related to the use of derivatives by registered investment companies, including funds, which the SEC adopted in October 2020. Unlike the previous amendment, which had two separate tests for derivatives depending on the NAIC Fund List on which a fund is listed, this amendment would create a single test. Pursuant to the new proposal, a fund's exposure to: 1) derivatives under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payments or otherwise; 2) short sale borrowings; and 3) reverse repurchase agreements or similar financing would be limited to 10% of the fund's net assets in normal market conditions. Exposure would be calculated based on the gross notional amounts of derivatives, the value of assets sold short for short sale borrowings, and the proceeds received by the fund but not repaid for reverse repurchase agreements. Consistent with the SEC Rule, interest rate derivatives and option contracts exposure could be calculated with other defined methods consistent with market practice. Also consistent with the rule, certain currency and interest rate derivatives that hedge currency or interest rate risk associated with one or more specific equity or fixed-income investments of the fund would be excluded from the 10% exposure calculation.

One difference between this proposal and the SEC Rule is that the P&P Manual's methodology requires a look-through assessment of all funds which, in turn, includes a requirement that a fund "predominantly hold" bonds or preferred stock, as applicable. As defined in the P&P Manual, "predominantly hold" means that a fund holds at least 80% of its assets in bonds or preferred stock, depending on the type of fund, in normal market conditions. This existing requirement, therefore, limits total derivatives, short sale borrowing, and reverse repurchase agreement exposure in any fund to 20%, exclusive of the excluded currency and interest rate derivatives. The amendment proposes calculating that exposure as previously explained, using gross notional amount for the derivatives. However, for derivatives under which a fund is not or a fund shall not be required to make any future payment or delivery of cash or other assets, exposure would be calculated based on the derivative's market value, a less conservative measure than gross notional, due to diminished risk of loss to the fund. These derivatives would include, for example, certain options pursuant to which the fund would have no possible future payment obligation following the initial premium payment. The Credit Risk Assessment portion of the existing methodology would also be updated to include a calculation of derivative exposure and, if analytically appropriate, the inclusion of derivatives in the weighted average rating factor (WARF) analysis. Derivative documentation can be complex and its review time-consuming. To expedite reviews of funds with derivatives while ensuring that the fund does not breach the proposed exposure thresholds, the proposal includes a new filing requirement to include certain derivatives information in the schedule of portfolio securities and assets, which is provided to the SVO for its review. Such additional information would include: 1) derivative type; 2) whether the derivative will require the fund to make a future payment or delivery of cash or other assets; 3) whether the derivative is an "excluded derivative transaction;" 4) the counterparty credit rating; and 5) the derivative exposure and how it is calculated. The expectation is that a complete and accurate summary of derivatives in the schedule will prevent the need for the SVO to review derivative legal documentation, but the SVO will reserve the right to request it if it deems it necessary.

Based on comments received from interested parties, the SVO removed the initially proposed management assessment from this amendment. Interested parties expressed concern that the management assessment could further weaken market clarity and predictability.

Mr. Fry said this will add a lot of transparency and understanding of the use of derivatives, and it will be a welcome addition to the P&P Manual.

Mike Reis, representing the ACLI, the NASVA, and the PPiA, said this provides clarity. He said industry appreciates the thought that went into the proposal and fully supports the exposure. It serves multiple purposes that are beneficial to everyone. One thing that was highlighted in the comment letter was that for some of the funds that get a designation, the risk-based capital (RBC) does not flow through from that designation, specifically, those funds in *Statement of Statutory Accounting Principles (SSAP) No. 30R—Unaffiliated Common Stock*. There has been talk in the past of potentially getting the RBC to be reflective of the NAIC designation on those funds. That change may have to go to the Capital Adequacy (E) Task Force and industry is certainly supportive of that change. There are certain things happening in the bond project at the Statutory Accounting Principles (E) Working Group, and there may be a population of other securities that would also benefit from some type of look through for RBC treatment as well.

Eric Hovey (Payden & Rygel) said Payden & Rygel had commented on the earlier version and appreciates that the input was taken, supports the new version, and appreciates the continued movement forward in looking at ways to treat bond mutual funds with look through assessment for capital treatment more aligned to the holdings of securities. Also, the SEC rule that is being mentioned here is not in force until August 2022 for the investment industry. There is a little bit of timing mismatch as far as the industry coming to terms exactly with what will be done for that rule versus this proposal being put forth today.

Ms. Mears made a motion, seconded by Mr. Milquet, to adopt the updated proposed amendment to the P&P Manual to add additional instructions to the review of funds. The motion passed unanimously.

4. <u>Adopted an Amendment to the P&P Manual to Permit FE for CTLs and Ground Lease Financing Transactions.</u>

Mr. Fry said the next item on the agenda is to discuss and consider for adoption an amendment to the P&P Manual to permit FE for CTLs and ground lease financing transactions. This is a change from the existing policy where these transactions had to be filed with the SVO for a legal, structure and credit assessment and only allow the residual asset exposure up to 5% of the original loan amount. This amendment was exposed on May 28 for a 30-day public comment period ending June 28. The Task Force has received two comment letters that were supportive of the amendment.

Charles A. Therriault (NAIC) said the Statutory Accounting Principles (E) Working Group chairs proposed updating the definition of CTL and ground lease financing (GLF) transactions in the P&P Manual to limit them to only those investments that would meet the definition of a mortgage loan under *SSAP No. 37—Mortgage Loans*. Investments that are securities (which are expressly excluded from SSAP No. 37) that fall under the definition of *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities* would no longer meet the definition of a CTL and ground lease financing transactions in the P&P Manual and would, therefore, become eligible for FE, which includes private rating letters. The SVO can still review these transactions and refer to the CTL and GLF methodologies for any unrated security that is CTL-like or ground lease financing-like that requires filing with the SVO, as would any other unrated security. If this amendment is adopted by the Task Force, the SVO will look to see if there are any rated CTL or GLF transactions in the VISION application, remove the SVO assigned NAIC designation from them, and permit them to flow through FE.

Mr. Fry said that originally this was created for transactions that were mortgage loans that wanted to be on Schedule D, and over time, these types of structures made their way into being securities. The policy in the past has been that even if it was a security, it still had to be filed with the SVO and looked at for these characteristics. The Task Force recognizes that there are other securities that do not have to go through this type of criteria. There is also the *SSAP No. 43R—Loan-Backed and Structured Securities* project at the Statutory Accounting Principles (E) Working Group that will complement this in the future if it gets adopted.

John Garrison (Lease-Backed Securities Working Group) said the Lease-Backed Securities Working Group appreciates the consideration and thought that went into this proposal.

Mike Reese (Northwestern Mutual), representing the ACLI, NASVA and PPiA, said this has had a lot of discussion over the past year. Industry is happy that these securities will receive similar treatment to other securities, and this change dovetails with the *SSAP No. 43R—Loan-Backed and Structured Securities* project at the Statutory Accounting Principles (E) Working Group.

Mr. Thomas made a motion, seconded by Mr. Fletcher, to adopt the proposed amendment to the P&P Manual permitting securities similar to CTL and GLF transactions to use NAIC credit rating provider (CRP) ratings through the FE policy. The motion passed unanimously.

5. <u>Adopted Guidance for WCFIs Consistent with the Statutory Accounting Principles (E) Working Group's Adopted of Changes to SSAP No. 105R and Exposed an Amendment Permitting the SVO to Rely Upon the Unrated Subsidiaries of a CRP-Rated Parent Entity for Only WCFIs</u>

Mr. Fry said the next item on the agenda deals with working capital finance investments (WCFIs). This was last exposed on Nov. 18, 2020, during the Fall National Meeting. There are two separate amendments. One amendment deals with the changes that the Statutory Accounting Principles (E) Working Group made to *SSAP No. 105R—Working Capital Finance Investments* and brings the P&P Manual into alignment with those changes. No comments were received on those changes. The second amendment deals with unrated subsidiaries, and it was exposed in November too but there were comments and updates made to that amendment. It is likely that the second amendment will be re-exposed and also referred to the Statutory Accounting Principles (E) Working Group.

Marc Perlman (NAIC) said the first WCFI amendment the SVO is proposing is unchanged since it was exposed in November 2020. It is intended to remove from the P&P Manual inconsistencies that arose when SSAP No. 105R was revised.

Under the second proposed WCFI amendment, when a WCFI obligor is unrated, cannot be designated by the SVO and is not guaranteed by its parent, the Task Force would direct the SVO to rely on the rating or NAIC designation of an obligor's parent based on its implied support. With this second iteration of the policy amendment, the SVO is recommending certain changes.

First, the initial test for whether the SVO should be able to rely on the parent's rating required that the obligor constitute a "substantial portion of its parent's operations representing at least 25% or greater of the parent entity's assets, revenue and net income." The SVO proposes removing this requirement since it was deemed too restrictive and could prevent, for example, a 5% subsidiary, which manufactures a crucial component for its parent's product, from benefiting from the policy. Additionally, interested parties explained that they did not think it would always be possible to determine the percentage of the parent's operations because it is not always clear from the parent's financial statements, and the subsidiary often lacks financial statements.

Second, the initial proposal allowed the SVO to notch the designation down from that of the parent based on several subjective factors related to the parent/obligor relationship. The notching provisions were removed so that, according to the policy, the SVO will only imply the parent's rating on the obligor without notching. However, under the policy, the SVO expressly retains its right, in its sole analytic discretion, to notch the designation or choose not to assign a designation to a WCFI program for reasons unrelated to the relationship between the obligor and its parent.

Lastly, there is one clerical correction to the amendment. Where it currently references "eligible NAIC CRP rating" throughout, the word "eligible" was removed because an eligible NAIC CRP credit rating specifically refers in the P&P Manual to ratings assigned to securities eligible for Schedule D reporting. Since the rating on a parent could be an issuer rather than an issue rating, it might not meet the definition of "eligible NAIC CRP credit rating."

Mr. Fry said it would be easiest to consider the two amendments separately. The first amendment brings the P&P Manual into alignment with SSAP No. 105R. It has been previously exposed, and Mr. Fry asked if the ACLI, whose comment letter discussed both amendments, would like to specifically address this first amendment,

Mike Monahan (ACLI) said that the ACLI supports amending the language to agree with SSAP No. 105R and moving forward with the first amendment.

Mr. Fry ask Mr. Therriault for the SVO's recommendation. He recommended adoption of the first amendment to align the P&P Manual to the adopted changes with SSAP No. 105R. Mr. Monahan said the ACLI supports that recommendation.

Mr. Fry said that the second amendment deals with the unrated subsidiary piece and asked if there were any comments on it. Mr. Monahan said the ACLI is supportive of what the Task Force has done and will comment on the exposure. He said it is a safe asset class for large insurers.

Mr. Everett asked if industry might be able to address in their comments some questions he had, and that is that SSAP No. 105R now requires an obligor rating, and the parent will not be the obligor. The SVO indicated that a methodology for these kinds of things is lacking and, in light of the Greensill supply chain financing situation, it has become clear that not even generally accepted accounting principles (GAAP) has any standards for supplier finance programs. Standard & Poor's (S&P) just had a seminar and released a research paper on supply chain finance disruptions. Mr. Everett said if possible, if industry could distinguish the situation from Greensill and address the standards issue in their comment letter, it would be appreciated.

Mr. Monahan said they are on top of what happened with Greensill and have been working with the Financial Standards Accounting Board (FASB) on disclosures so that it is more transparent to users of financial statements.

Mr. Thomas made a motion, seconded by Ms. Doggett, to adopt proposed amendments to the P&P Manual to conform the WCFI guidance to reflect the changes adopted by the Statutory Accounting Principles (E) Working Group to SSAP No. 105R. The motion passed unanimously.

The Task Force also directed the SVO to expose the amendment to direct the SVO to rely upon the unrated subsidiaries of a CRP rated parent entity for only WCFI for a 30-day public comment period and refer it to the Statutory Accounting Principles (E) Working Group for comment.

6. Received a Report on Projects Before the Statutory Accounting Principles (E) Working Group

Julie Gann (NAIC) said the Statutory Accounting Principles (E) Working Group has three meetings scheduled for the near future. The Working Group plans to meet July 29 in regulator-to-regulator session, pursuant to paragraph 6 (consultations with NAIC staff members) of the NAIC Policy Statement on Open Meetings, to hear state insurance regulator reports regarding financial statement information from the 2020 financial filings. The Statutory Accounting Principles (E) Working Group usually does that in conjunction with the national meetings, but since those have been hybrid sessions, there has not been the opportunity to do so. Any state insurance regulator who would like to have information on any disclosure can contact NAIC staff. There are a handful of items planned for presentation with regard to information that the Working Group has gathered from the financial statements. Some examples are the Federal Home Loan Bank (FHLB) disclosure, the SVO-identified exchange-traded funds (ETFs), the new cash pooling, and permitted practices. Ms. Gann said if anyone wants anything specific, let NAIC staff know.

Additionally, the Working Group plans to meet Aug. 10 in regulator-to-regulator session, pursuant to paragraph 6 (consultations with NAIC staff members) of the NAIC Policy Statement on Open Meetings, to discuss comments received on the Schedule - D project and on the *SSAP No. 97—Investments in Subsidiaries, Controlled and Affiliated Entities* exposure. It also plans to meet Aug. 26 to hear comments on proposed items..

Ms. Gann said with the action taken today on CTLs, Interpretation (INT) 2010 will be reviewed. It formally expires Oct. 1, but with the action that occurred today, that interpretation may no longer be needed. She said the Statutory Accounting Principles (E) Working Group will look at that and hopes to have an update for its Aug. 26 meeting.

7. Discussed Other Matters

Mr. Fry said there is an update from Eric Kolchinsky (NAIC) on updating the structured securities reporting for the legacy and non-legacy changes adopted this spring along with planning for the recently adopted updated RBC factors.

Mr. Kolchinsky said there are two broad categories of updates. The first is the announcement of the selection for the financial modelling request for proposal (RFP). It was a long and tough RFP, and the Structured Securities Group (SSG) selected BlackRock Solutions. There were some excellent bidders, and it was an interesting RFP. Mr. Kolchinsky said the SSG looks forward to working with BlackRock Solutions on many of the issues that are going to be discussed next.

Mr. Kolchinsky said the second issue is that the SSG has a number of overlapping changes that are happening with modeled securities: 1) there is BlackRock Solutions, a vendor that has worked with the SSG before; 2) there is the change from breakpoints to designations for non-legacy securities that requires a technical change; 3) there is through-the-cycle modeling; and 4) there are the changes to the RBC factors from Capital Adequacy (E) Task Force. The SSG and the SVO received a letter from the ACLI discussing many of these issues on financially modeled securities that the SSG will look at with the SVO. The SSG staff are in general agreement with the ACLI letter as to how to prioritize the rollout of all these changes and appreciates the letter in general. The letter has not been exposed yet. There are some issues that are short on details that the SSG needs to work out such as implementation of the zero-loss framework. Mr. Kolchinksy said the SSG may come back to the Task Force to discuss these issues, and there may be a need for some minor changes to the P&P Manual. The biggest issues is moving the implementation of both the breakpoints and on the new 20 designation categories using the new RBC factors into 2022. The rationale for moving this into 2022 is that it will give the SSG the opportunity to think through these changes and bring it to Valuation of Securities (E) Task Force for approval instead of rushing it in for year-end 2021, given all these other changes.

Francisco Paez (MetLife) said, there are a number of changes that are happening on the RBC front, not only on the bond side, but also in other parts of the business, and structured securities is part of that equation. It was important to keep that in consideration. There are changes that industry hoped would get done on the modelled security side to address the issues encountered last year. There is also an operational component, and one thing that industry wanted to make sure of is that things are managed in a way that do not lend themselves to any kind of last-minute operational complexities or risks that are not necessary. The letter recommends prioritizing the orderly adoption of these changes and makes suggestions in terms of which changes are most meaningful to industry to achieve some balance.

Mr. Fry asked if when mentioning year-end 2021 and the 20 designations, is this considering only the six designations for this year-end and then going with 20 designations for next year, 2022.

Eric Kolchinsky said that is correct. He said what would occur is that the reporting would still be as currently defined in the P&P Manual. There is already a provision for reporting the NAIC designation categories. In terms of calculating the breakpoints between the layers, as well as for the designations, that is a process the SSG would like to do on a more interactive basis with the Valuation of Securities (E) Task Force and not do it hastily, considering everything else that needs to be done for this year-end. He said the SSG would also like to run a few more scenarios, given the extra granularity that will be seen now in the 20 versus the six designations. SSG staff are concerned that having just four scenarios will force the results to bunch up in just a few categories, which understates or overstates the risk to the securities. SSG staff would like to take the year of 2022 to discuss these issues with Task Force and report for the current year with the existing designation categories.

Mr. Paez said what was done last year in terms of mapping of securities is a little bit of a road map that could be used again this year. That way, there can be six categories but still mapping on to the new designation categories where they map to the middle of the designation category. The only point that is going to be important for industry is that those bonds that meet the highest quality definition can make it to the 1.A category. There may be a need for enhancements to the scenarios in order to capture all the granularity. Thinking specifically about this year-end and the path that was used last year could be replicable this year. Mr. Paez said all that would be needed to do is figure out a way to address that 1A category, which, in the absence of more detail, the methodology for the zero loss could be that indicator that allows the mapping to the 1.A category. It should capture really what it is supposed to capture because most of those securities are going to be AAA securities.

Eric Kolchinsky said, in general, SSG staff agreed, but they need to work through it and the operational concerns. The new breakpoint file will need 19 columns instead of five. Vendors on the industry side will need to figure out how to take in the new files, and not having to rush is a huge benefit. Mr. Therriault said the SVO will expose the ACLI comment letter on the Task Force web page.

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/01 - Meeting minutes/VOSTF 2021 Summer National Meeting Minutes (FINAL).docx

Draft: 10/27/21

Valuation of Securities (E) Task Force
Virtual Meeting
September 30, 2021

The Valuation of Securities (E) Task Force met Sept. 30, 2021. The following Task Force members participated: Dana Popish Severinghaus, Chair, represented by Kevin Fry (IL); Doug Ommen, Vice Chair, represented by Carrie Mears (IA); Lori K. Wing-Heier represented by Wally Thomas (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Carolyn Morgan (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 (MO); Marlene Caride represented by Nakia Reid and John Sirovetz (NJ); Adrienne A. Harris represented by Jim Everett (NY); Cassie Brown represented by Amy Garcia (TX); Jonathan T. Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); and Mike Kreidler represented by Tim Hays (WA).

1. Adopted its 2022 Proposed Charges

Mr. Fry said the Task Force's 2022 proposed charges are unchanged, but there was a charge inadvertently omitted in the materials for the Summer National Meeting. That omission has been corrected along with the deletion of a reference to the Investment Risk-Based Capital (E) Working Group, which has been disbanded.

Mr. Thomas made a motion, seconded by Ms. Clements, to adopt the Task Force's 2022 proposed charges (Attachment Three). The motion passed unanimously.

2. Exposed a P&P Manual Amendment to Add the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" List

Mr. Fry said the next agenda item is to discuss an amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to add the U.S. International Development Finance Corporation (DFC) to the "U.S. Government Full Faith and Credit – Filing Exempt" list. This list reflects entities that are instrumentalities of the U.S. government, and the debt obligations issued by them must be fully guaranteed or insured as to the timely payment of principal and interest by the full faith and credit of the U.S. government. Satisfying this high standard permits them to be Filing Exempt (FE) and reported as an NAIC Designation Category of 1.A.

Marc Perlman (NAIC) said an industry participant requested that the Securities Valuations Office (SVO) add the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" list in Part One of the P&P Manual.

In October 2018, the Better Utilization of Investments Leading to Development (BUILD) Act was signed into law. The BUILD Act reorganized and merged existing U.S. government development finance and aid programs, the Overseas Private Investment Corporation (OPIC), and the Development Credit Authority (DCA) of the U.S. Agency for International Development (USAID) into a new agency; i.e., the DFC. The purpose of the DFC is to facilitate the participation of private sector capital and skills in the economic development of less developed countries and countries transitioning to market economies, while advancing U.S. foreign policy interests. It is authorized to do so by making loans or guaranties according to terms and conditions specified in the BUILD Act.

Pursuant to the BUILD Act, the support provided by the DFC and existing support provided by the OPIC and USAID shall continue to constitute obligations of the U.S., and the full faith and credit of the U.S. is pledged for the full payment and performance of its obligations. The DFC is authorized to borrow from the U.S. Department of the Treasury (Treasury Department) to fulfill such obligations of the U.S. government.

Based on this express full faith and credit, the SVO recommends adding the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" list in Part One of the P&P Manual. The SVO recommends maintaining the OPIC and USAID on the list even though they have been subsumed by the DFC, because certain obligations of those agencies may still be outstanding.

For the avoidance of doubt, any security issued by an entity on the "U.S. Government Full Faith and Credit – Filing Exempt" list shall be filed with the SVO if the security is not fully guaranteed by the U.S. government. For certain entities on the list, statute may require parties other than the U.S. government full faith and credit guarantor to bear a risk of loss equal to a specified percentage of the guaranteed support. For example, the BUILD Act requires parties to a project to bear the risk of loss in an amount of at least 20% of the guaranteed support of the DFC. If an insurance company, as investor, is the party bearing that risk of loss, meaning the securities it purchased are not fully guaranteed by the DFC or another entity on the list, it would need to file those securities with the SVO.

The P&P Manual explains that the SVO has no compliance mechanism for these U.S. government obligations and encourages insurers that are uncertain about the FE status of a security to either file it with the SVO or use the Regulatory Treatment Analysis Service (RTAS) – Emerging Investment Vehicle process.

Mr. Fry directed the SVO to expose this P&P Manual amendment for the addition of the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" list for a 30-day public comment period ending Oct. 30.

3. Adopted a P&P Manual Amendment to Add Spanish GAAP to the List of Countries and Associated National Financial Presentation Standards

Mr. Fry said the next agenda item is to discuss and consider for adoption an amendment to the P&P Manual to add Spanish Generally Accepted Accounting Principles (GAAP) to the list of Countries and Associated National Financial Presentation Standards. There is a specific process that must be followed in the P&P Manual to add to the list of accepted National Financial Presentation Standards. Unlike other amendments that the Task Force considers, this process concludes with an assessment and recommendation by the SVO regarding whether the requested national accounting standard leads to an NAIC Designation analogous to those created by the use of a global financial presentation standard such as U.S. GAAP or International Financial Reporting Standards (IFRS).

Charles Therriault (NAIC) said in 2013, the Task Force adopted a procedure, outlined in Part Two, paragraphs 174–181 of the P&P Manual, on how to submit requests to consider other National Financial Presentation Standards and what steps must occur. The process and actions taken are as follows:

- *A national insurance association (but not individual insurers or other persons) may, by written request, ask the SVO to study the feasibility of adding a country and the associated National GAAP or National IFRS.*

  In March 2021, the SVO received a letter from the American Council of Life Insurers (ACLI) requesting the SVO to consider the National GAAP/National IFRS of Spain for addition to the National Financial Presentation Standards.

- *The national insurance association will, as necessary, identify an accounting firm that is an expert in the national accounting system of the country proposed for inclusion on the list of Countries and Associated National Financial Presentation Standards.*

  The requirement of this step has been fulfilled. The ACLI identified Deloitte of Spain as an expert in the national accounting system of Spain.

- *The national insurance association will work with the SVO to create an educational session on those aspects of financial presentation relevant to the SVO for the purposes of its credit risk assessment.*

  This requirement has been fulfilled. On June 22, Joaquin Sánchez-Horneros, Director and member of the IFRS Centre of Excellence at Deloitte Spain, along with Pablo Castillo Lekuona, Senior Manager in the Department of Global Capital Markets and Accounting IFRS, gave a presentation to SVO analysts.

- *The educational session will focus on the material differences between accounting methods for the income statement and balance sheet and shall include such further or additional areas as the SVO shall deem necessary in view of the specific country and national accounting system proposed.*

The June 22 presentation by Deloitte included detailed differences between Spanish GAAP and IFRS, including a case study demonstrating the financial statement impact on a company over three years, comparing IFRS to Spanish GAAP.

- *At the conclusion of such educational sessions, the SVO shall assess whether the educational session provides a sufficient basis for it to make needed adjustments to the financial information presented under the national accounting standard.*

  Based on the Deloitte presentation, including the reconciliation case study, it appears that most differences between Spanish GAAP and IFRS can be identified with additional disclosure sufficient to allow an analyst to make any necessary adjustments to an analysis.

- *The SVO shall then assess whether the application of the adjustments in one or more transactions confirms that the use of the national accounting standard leads to the creation of NAIC Designations analogous (in the information they convey about credit risk) to those created by using a Global Financial Presentation Standard.*

  The presentation of the Spanish GAAP review by Deloitte was sufficient for the SVO to draw conclusions as to the ability to analyze credits presented under these accounting guidelines.

The SVO recommends that Spanish GAAP be added to the list of Countries and Associated National Financial Presentation Standards in the P&P Manual, with the additional disclosures noted in the amendment. Catherine Cosentino (NAIC) and Rosemarie Kalinowski (NAIC), the SVO analysts that performed the study, will review the principal differences between Spanish GAAP and IFRS, along with the requested mitigants.

Ms. Cosentino said in reviewing Spanish GAAP versus IFRS, the following differences were identified:

- Operating Leases – Spanish GAAP do not bring these leases on to the balance sheet; they are accounted for as operating leases. Operating lease income and expense corresponding to the lessor and lessee are considered to be income and expenses of the year in which they accrue, respectively. The impact is that lessor income is higher and lessee income is lower than that reported for IFRS, and debt is lower than that of IFRS if adjustments are not made.
- Government Grants – Spanish GAAP initially accounts for the grants as equity and subsequently charges it to the income statement as amortization over time, whereas IFRS prohibits recognizing them immediately as equity. The impact is that equity will be inflated for capital grants, and related debt to cap will be lower than it would be if calculated under IFRS.
- Intangible Assets – Spanish GAAP allows research and development costs to be capitalized with a presumption of a useful life limit of five years. IFRS does not allow research costs to be capitalized. It allows development costs to be capitalized under certain requirements, which will be amortized over their useful life. The impact is that assets are higher than under IFRS since research is capitalized and net income will be lower because of the goodwill amortization, and assets and equity will be undervalued relative to IFRS.
- Financial Instrument (valuation) – Spanish GAAP values financial assets at lower acquisition cost and market, while financial liabilities are valued at repayment value. All changes in fair value of financial liabilities are recognized in the income statement. For IFRS, financial assets are valued at fair value, while financial liabilities are valued at amortized cost. All changes in fair value of financial liabilities are recognized in equity. The impact is that asset value will be understated relative to IFRS if fair value and cost are different. Regarding financial liabilities, changes in fair value will affect the income statement under Spanish GAAP, which could affect financial ratio calculations involving net income, as well as the calculation of earnings before interest, taxes, depreciation, and amortization (EBITDA).
- Financial Instrument (available for sale) Impairment/Reorganization – Spanish GAAP allows for fresh-start accounting in certain situations, while IFRS does not recognize fresh-start. The impact is that reported assets may be overstated under Spanish GAAP.
- Joint Ventures – Spanish GAAP allows for proportionate consolidation, but if it is a 50/50 joint venture, then the equity method can be used. For IFRS, only the equity method is used. The impact is that revenue and operating income will be higher than under IFRS if proportionate consolidation is used. This is likely to significantly distort results if a company has large joint venture holdings.

As just mentioned, there are several important differences between Spanish GAAP and IFRS that will require mitigants. The items referenced will require additional audited disclosures either in the notes to the financial statements or as supplemental disclosure, thereby allowing the SVO to adjust the financial statements so that the use of Spanish GAAP will have no impact on the ultimate NAIC Designation. Some of these disclosures may not be contained in the notes to Spanish GAAP financial statements; therefore, the following items should be submitted, along with the Spanish GAAP statements:

- A complete set of audited financial statements, which includes balance sheet, income statement, and consolidated statement of cash flows for at least one year, three years, if available.
- Disclosure of operating lease commitments in a manner similar to that required by IFRS or US GAAP.
- Disclosure of government grants, including initial amount and year-to-date (YTD) and cumulative amortization.
- Disclosure of gross capitalized research costs and cumulative amortization.
- Disclosure of gross goodwill and cumulative amortization, including goodwill created by fresh-start accounting.
- Disclosure in the change in fair value for financial assets and liabilities.
- Disclosure on joint ventures not using the equity method, including full financial results.

Mr. Fry said the SVO made a recommendation to accept Spanish GAAP statements if these disclosures are provided, which has been done for other countries. Mr. Fry asked if any Task Force members object to considering this for adoption, and there were no objections. Michael M. Monahan (ACLI) said the ACLI has reviewed all the required disclosures and agrees that they are fair and adequate; the ACLI supports adoption at this meeting.

Ms. Mears made a motion, seconded by Mr. Thomas, to adopt the amendment to the P&P Manual to add Spanish GAAP to the list of Countries and Associated National Financial Presentation Standards. The motion passed unanimously.

4. <u>Exposed a Proposed Amendment to the P&P Manual to Add Bank Loans</u>

Mr. Fry said the next item on the agenda is to receive and discuss a P&P Manual amendment to include bank loans in the definition of obligation.

Mr. Perlman said since 2018, the *Accounting Practices and Procedures Manual* (AP&P Manual) has included bank loans issued directly by a reporting entity or acquired through a participation, syndication, or assignment in *Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds*. Pursuant to SSAP No. 26R, bank loans means fixed-income instruments, representing indebtedness of a borrower, made by a financial institution.

To maintain consistency with the bond definition in SSAP No. 26R, the SVO proposes amending the P&P Manual to clarify that the SVO can assess and assign NAIC Designations to bank loans and the relevant filing instructions and methodology for them. The filing instructions and methodology would follow that of other corporate obligations.

Mr. Everett asked if given that a lot of these bank loans are not securities, they are different from bonds, they are treated differently, and they are regulated differently with different trade mechanics, there is a way to get an assessment on how these would be assessed compared to bonds.

Mr. Therriault said the traditional methodology would follow that of a corporate bond. A bank loan credit risk would not be viewed differently than a corporate bond credit risk; it would be the same analysis process. They are securities reported on Schedule D with other bonds.

Mr. Everett said there are differences as to trading and other things like that, and their seniority in bankruptcy is not being considered. Mr. Therriault said the SVO would consider those issues in the analysis of any corporate security; i.e., its relative position in the capital structure, how much debt is involved, and whether there is any collateral involved that will support the security. Those are all things normally considered for any security. Mr. Perlman said the SVO considers this a clarification amendment for consistency with the SSAP and not an addition.

Mr. Everett asked if there would be a distinction between secured and unsecured loans. Mr. Perlman said it would be looked at as with a corporate debt, and it is part of the methodology currently in the P&P Manual. Mr. Therriault said this amendment is adding bank loans as a footnote to the corporate debt methodology. There is not a separate methodology section being introduced; the corporate methodology will be applied to bank loans.

Mr. Fry ask how this is identified in SSAP No. 26R. Mr. Perlman said it is listed under the bond definition. Bank loans are listed separately in the back of SSAP No. 26R; there is an exhibit with a glossary with definitions, and that is what is being referred to in the amendment. Mr. Fry said it should be made clear that this is a type of security that falls under what the SVO can review and apply this methodology towards. Mr. Therriault said there is a section in the P&P Manual with a header for bank loans, but it did not have any substance. This amendment is to include bank loans in the corporate methodology section as a footnote and remove that header.

Mr. Everett asked if the securities being discussed are for federal antifraud purposes or just for reporting. If they are securities under the Federal Reserve Act, then they are like bonds, and disclosures must be made. But if they are bank loans, then the disclosure and fraud requirements of the securities laws will not apply. Mr. Therriault said the SVO does not make that level of distinction and neither does the SSAP. Mr. Everett said if they are not securities, then they are not within the purview. Mr. Therriault said the amendment is following the definition of SSAP No. 26R. Mr. Everett said disclosures that are made under the possible sanction of federal securities laws are often different from those that are made outside of those laws. If there is a default in a bank loan, the recovery and cure procedures are dependent on whether the loans are secured or unsecured and where they fit within Articles 8 or 9 of the Uniform Commercial Code (UCC). Those are key differences between loans and bonds, and that is where the question is coming from. Mr. Perlman said there are securities that are unsecured. Mr. Everett said not all loans are securities. Mr. Perlman said Article 9 could also apply to a security with a security interest. Mr. Everett said there is a difference in the priorities setting under Article 9. Mr. Therriault said the SVO looks to see whether there is support to ensure that payments are made. But if there is no credit support, there will be no benefit to collateral if it is not intended to provide a means by which to make payments to the investor. The point of the NAIC Designation is the expectation that principal and interest will be paid on a timely basis. It does not go through the default and recovery process that may occur in bankruptcy.

Mr. Everett said there are also differences in the way they bank loans are traded, which affects liquidity. Mr. Therriault said he would expect liquidity concerns to be reflected in the market value. Mr. Everett said in a bond, there is a promise to pay, but in a syndicated loan, there is an investor that is subject to the decision of the syndicator to collect on the loan.

Mr. Fry directed the SVO to expose the amendment to add bank loans to the definition of obligation to the P&P Manual for a 30-day public comment period ending Oct. 30.

5. <u>Exposed a Proposed Amendment to the P&P Manual to Add Zero-Loss Criteria for Legacy-Modeled RMBS and CMBS</u>

Mr. Fry said the next item on the agenda is to receive and discuss a P&P Manual amendment to add back zero-loss criteria for legacy-modeled residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS).

Mr. Therriault said this was initiated from a memo received from the ACLI requesting that the zero-loss rules be applied back to Part Four of the P&P Manual for RMBS and CMBS. The amendment that is being proposed is to add back the zero-loss criteria and map it to an NAIC Designation Category 1.A. for legacy RMBS or CMBS that are financially modeled and experience zero-losses underneath any of the scenarios being run. As the Structured Securities Group (SSG) moves forward next year in 2022, some of the new scenarios will probably need to be updated in the P&P Manual, but this amendment will provide guidance through year-end 2021. There was a desire to move this through quickly so insurers would know as soon as possible that the Task Force has approved this amendment and they can move forward with system changes and other modifications that may be necessary to accommodate the update.

Tracy Lindsey (North American Securities Valuation Association—NASVA) thanked the SVO for acknowledging the impact to insurers and turning this around quickly to get it into the regulatory systems. Vendors will need to release a change, because it is a late adoption, but completely support the change. Mr. Monahan also said the ACLI appreciates the SVO's sensitivity of timing in getting this change implemented, and it would support a short exposure period of 10 or 15 days.

Mr. Fry directed the SVO to expose the amendment to the P&P Manual to add back zero-loss criteria for legacy-modeled RMBS and CMBS for a 15-day public comment period ending Oct. 15 and conduct an e-vote if there are no substantive comments.

6. <u>Heard a Report from the SSG on the Year-End Process</u>

Eric Kolchinsky (NAIC) reviewed a presentation for the SSG's year-end modeling process. The SSG is running through-the-cycle scenarios for RMBS. For CMBS, the SSG is using the normal approach that was used previously. There was an adjustment to the base case; the base case last year had a huge impact for COVID-19, and it was adjusted to make a much smaller impact for COVID-19 this year. There is still a lot of uncertainty, especially in CMBS, but this time, the uncertainty is sort of broad. Last year, it was known that things were going to get worse. In the current case, it is not clear that anyone has a good idea of what will happen. A lot of stress has been taken out of the base case scenario.

The SSG will be implementing zero-loss for legacy bonds. It will be a "Y/N" column in the appropriate file. The securities that are zero-loss for non-legacy will be assigned an NAIC Designation Category 1.A. The others will follow the mid-NAIC Designation categories for each one. The threshold for zero-loss and break points are to be determined and will be disclosed. There will be a mid-year update based on what is expected for scenarios, up-to-date financials, and on a pro forma basis by the end of October or early November. The SSG and BlackRock have been working very hard on this.

The SSG will likely introduce several through-the-cycle scenarios in 2022, both for RMBS and CMBS. The SSG is targeting between eight and 12 scenarios because 19 thresholds or break points will be needed. If only four scenarios were kept, there would be bonds clustering around one or the other. This is intended to be a lot more sensitive, and there is no intention to change which way things go, better or worse. The SSG would like to create something aligned with what has been done in the prior distributions but just a little bit more sensitive, given that there will be many more thresholds or break points. This will be brought to the Task Force for its approval, along with the 19 thresholds and break points based on the new risk-based capital (RBC) standards that were set out.

Zero-loss will not apply to non-legacy that will be assigned NAIC Designation Category 1.A for the smallest loss possible. The SSG would also consider, depending on demand, a mid-year update file 2022 if there is interest. Resecuritizations of real estate mortgage investment conduit (Re-REMICs), in terms of what is a legacy or non-legacy, the SSG looks through to the underlying and if the underlying is legacy, it is treated as legacy for break point or NAIC Designations. The other question is the format; there will be two files: a file for legacy securities and another for non-legacy securities. The legacy securities file will look very much like the old file. The non-legacy will look like the Automated Valuation Service (AVS+) file. The NASVA and third-party administrators (TPAs) have been working on all of these files.

Francisco Paez (MetLife) said the approach is clear with the legacy securities with the "yes" or "no" indicator for zero-loss mapping to NAIC Designation Category 1.A. He asked whether non-legacy securities, the ones that do not have any loss, are mapped to NAIC Designation Category 1.A also or if the SSG provides the NAIC Designation. Mr. Kolchinsky said that is correct, those securities that meet the threshold for no loss will be assigned an NAIC Designation Category 1.A directly in the file.

At the beginning of the year, removing the zero-loss completely was discussed. There has since been a request from the ACLI to include it again. For legacy securities, this is becoming a smaller group each year. The SSG does not see an issue with adding back the zero-loss concept for legacy securities; however, since the language was taken out of the P&P Manual, it needs the Task Force's approval to add it back, which is the request in the prior agenda item. Once the new categories and the new approach for 2022 for the 19 break points and thresholds are set, there will be additional P&P Manual updates needed for next year.

Mr. Fry asked what the ramifications would be if the Task Force does not support adding zero-loss securities. Mr. Kolchinsky said an analysis of the ramifications has not been conducted. He said he supports adding back the zero-loss case for the legacy securities to maintain the status quo from last year and the prior years.

Mr. Paez said the inclusion of the zero-loss securities this year avoids a more asymmetric treatment of modeled security versus other bonds at the AAA level. Most zero-loss securities in modeled securities that are non-legacy are really going to be AAA, and they represent by and large the biggest component of the capital structure of securitizations. From that perspective, including it gives a symmetric treatment of AAA structured securities or non-structured securities.

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

Ms. Lindsey asked to quickly discuss the status of private rating letters, providing rationale to the SVO, and what that looks like starting Jan. 1, 2022. This was an adopted change, and industry has been working with rating agencies to ensure that they provide that information starting Jan. 1, 2022 and looking at the current private rating letter population to see which ones have rationale that can be provided to the SVO starting Jan. 1, 2022. The NASVA met with the SVO and some folks from Kansas City Managed IT to discuss what that will look like for filers, and it sounds like it will take some time to get VISION and AVS+ updated to accommodate the changes in the filings. Feeds will be a ways out, and manual filings could be a bit of a challenge in the short term. There was a discussion about timing and what implementation looks like or what the expectations are from state insurance regulators if it is mid-year next year versus Jan. 1.

Mr. Therriault said the expectation is that there will be a VISION enhancement next year to permit the filing of the private letter (PL) rating rationale reports. Hopefully that will be done by mid-year, but that is not certain. It will be a transition over time. The NAIC has spent a tremendous amount of energy this past year on making the modifications necessary for the financially modeled securities. Filers can submit those rational reports if there is a manual PL rating filing, to the extent that they are available. They can also be emailed to the analyst, as necessary, and the SVO will start accumulating them. The expectation is that the VISION application, which is the system that houses all our filings from insurers, will have an acknowledgment field somewhere in the system to be able to identify that a ratings rationale report has been received for the current year. This will permit insurance companies to know whether it was received. It will take time to build out this enhancement, and progress updates will be provided to industry and the Task Force, certainly at each of the national meetings.

Mr. Fry asked for clarification that the adopted amendment require ratings rationale reports to be filed by Jan. 1, 2022. Mr. Therriault said that is correct starting Jan. 1, 2022 but they can be submitted any time during the year.

Mr. Fry said the workaround is to manually send them in until such time as the system can handle them, and the SVO will update the Task Force periodically in between.

Mr. Therriault said there will be manual processes until VISION can be updated, and for a physical PL rating, the rationale report can be attached as an additional document when submitted.

Mr. Lindsey asked if it would it be fair to tell the reporting folks to hold off on that PL suffix until closer to the end of the year, because that is one indicator as to whether the rationale has been filed and accepted. Mr. Therriault agreed that would be fair.

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/01 - Meeting minutes/VOSTF 9.30.2021 Meeting Minutes (Chair review and approval).docx

Draft: 12/1/2021

Valuation of Securities (E) Task Force
Virtual Meeting
November 17, 2021

The Valuation of Securities (E) Task Force met Nov. 17, 2021. The following Task Force members participated: Dana Popish Severinghaus, Chair, represented by Kevin Fry (IL); Doug Ommen, Vice Chair, represented by Carrie Mears (IA); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone (CT); 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 (MO); Eric Dunning represented by Lindsay Crawford (NE); Marlene Caride represented by Nakia Reid (NJ); Adrienne A. Harris represented by Jim Everett (NY); Cassie Brown represented by Amy Garcia (TX); Jonathan T. Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays (WA); and Mark Afable represented by Michael Erdman (WI).

1. <u>Adopted an Amendment to the P&P Manual to Add the DFC to the U.S. Government Full Faith and Credit – Filing Exempt List</u>

Mr. Fry said the first agenda item is to discuss and consider adoption of an amendment to the *Purposes & Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) for the addition of the U.S. International Development Finance Corporation (DFC) to the "U.S. Government Full Faith and Credit – Filing Exempt" list. This list reflects entities that are instrumentalities of the U.S. government, and the debt obligations issued by them must be fully guaranteed or insured as to the timely payment of principal and interest by the full faith and credit of the U.S. government. Satisfying this high standard permits them to be filing exempt (FE) and reported as an NAIC designation category of 1.A.

Marc Perlman (NAIC) said this is an amendment to add the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" list in Part 1 of the P&P Manual. Under the 2018 Better Utilization of Investments Leading to Development Act (BUILD Act), the U.S. Overseas Private Investment Corporation (OPIC) and the Development Credit Authority of the U.S. Agency for International Development (USAID) were reorganized and merged into a new agency called the DFC. The purpose of the DFC is to facilitate the participation of private sector capital and skills in the economic development of less developed countries and countries transitioning to market economies, while advancing U.S. foreign policy interests. It is authorized to do so by making loans or guaranties according to terms and conditions specified in the BUILD Act.

Under the BUILD Act, the support provided by the DFC, and existing support provided by the OPIC and the USAID, shall continue, to constitute obligations of the U.S., and the full faith and credit of the U.S. is pledged for the full payment and performance of its obligations. The DFC is authorized to borrow from the U.S. Department of the Treasury (Treasury Department) to fulfill such obligations of the U.S.

Based on this express full faith and credit, the Securities Valuation Office (SVO) recommends adding the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" list in Part 1 of the P&P Manual and recommends maintaining the OPIC and the USAID on the list even though they have been subsumed by the DFC, because certain obligations of those agencies may still be outstanding.

For the avoidance of doubt, any security issued by an entity on the "U.S. Government Full Faith and Credit – Filing Exempt" list shall be filed with the SVO if the security's principal and interest are not *fully* guaranteed by the U.S. government. For certain entities on the list, statutes may require parties other than the U.S. government full faith and credit guarantor to bear a risk of loss equal to a specified percentage of the guaranteed support. For example, the BUILD Act requires parties to a project to bear the risk of loss in an amount of at least 20 percent of the guaranteed support of the DFC. If an insurance company, as investor, is the party bearing that risk of loss, meaning the securities it purchased are not fully guaranteed by the DFC or another entity on the list, it would need to file those securities with the SVO.

The P&P Manual explains that the SVO has no compliance mechanism for these U.S. government obligations and encourages insurers that are uncertain about the FE status of a security to either file it with the SVO or use the Regulatory Treatment Analysis Service (RTAS) – Emerging Investment Vehicle process.

Mike Reis (American Council of Life Insurers—ACLI and the North American Securities Valuation Association—NASVA) said the ACLI and NASVA support the proposal.

Ms. Doggett made a motion, seconded by Mr. Guerin, to adopt the amendment to the P&P Manual for the addition of the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" list. The motion passed unanimously.

2. Adopted an Amendment to the P&P Manual to Add Bank Loans

Mr. Fry said the next agenda item is to discuss and consider adoption of a P&P Manual amendment to include bank loans to the definition of "obligation."

Mr. Perlman said since 2018 the *Accounting Practices and Procedures Manual* (AP&P Manual) has included bank loans issued directly by a reporting entity or acquired through a participation, syndication, or assignment in *Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds*. Pursuant to SSAP No. 26R, "bank loans" mean fixed-income instruments, representing indebtedness of a borrower, made by a financial institution.

To maintain consistency with the bond definition in SSAP No. 26R, the SVO proposes amending the P&P Manual to clarify that the SVO can assess and assign NAIC designations to bank loans and the relevant filing instructions and methodology. The filing instructions and methodology would follow that of other corporate obligations. To be clear, SSAP No. 26R already includes bank loans in the definition of "bond," so this amendment would only align the P&P Manual to the AP&P Manual and would not be changing current statutory guidance.

Mr. Reis said the ACLI and NASVA support the proposal.

Mr. Fletcher made a motion, seconded by Ms. Reid, to adopt the amendment to the P&P Manual to add bank loans. The motion passed unanimously.

3. Exposed a Referral from the Statutory Accounting Principles (E) Working Group and a Proposed Amendment to the P&P Manual to Remove Residuals Tranches From Receiving an NAIC Designation

Mr. Fry said the next agenda item is to receive a referral from the Statutory Accounting Principles (E) Working Group and consider exposure of a proposed amendment to the P&P Manual to remove residual tranches from receiving an NAIC designation. Residual tranches capture securitization tranches and beneficial interests that reflect loss layers without any contractual payment of principal or interest. Instead, residual tranches are paid after contractual payments of principle and interests have been made to other tranches and are based on the remaining available funds.

Charles A. Therriault (NAIC) said the Statutory Accounting Principles (E) Working Group identified inconsistencies in how residual tranches and interests were being reported, with some entities reporting them on Schedule BA: Other Long-Term Invested Assets, and others reporting them on Schedule D-1: Long-Term Bonds with either self-assigned NAIC 5GI or NAIC 6 designations. To prevent further inconsistency and direct appropriate reporting, on Nov. 10, the Working Group adopted an amendment to SSAP No. 43R—Loan-Backed and Structured Securities to clarify that residual tranches and interests shall be reported on Schedule BA. To accommodate the time frame needed for a Blanks (E) Working Group proposal to expand reporting lines on Schedule BA to capture residual tranches and interests, the Working Group's amendment permits residual tranches and interests currently reported on Schedule D-1 to continue to be reported on Schedule D-1 for reporting year 2021 with an ultimate effective date of Dec. 31, 2022.

The SVO recommends that during this window when residual tranches currently reported on Schedule D-1 are permitted to stay on D-1, they should be allowed to do so only with an NAIC 6* designation and not an NAIC 5GI designation. This is consistent with the Working Group's adopted change. The NAIC 5GI designation is not appropriate for residual tranches and interests because according to the P&P Manual, an insurance company is permitted to self-assign an NAIC 5GI to an obligation if it meets all of the following criteria:

- Documentation necessary to permit a full credit analysis of the security by the SVO does not exist or an NAIC credit rating provider (CRP) rating for an FE or private letter (PL) security is not available.
- The issuer or obligor is current on all contracted interest and principal payments.
- The insurer has an actual expectation of ultimate payment of all contracted interest and principal.

Assignment of an NAIC 5GI designation for residual investments is an incorrect application of the guidance because: 1) there are no contracted interest and principal payments to certify as current; and 2) the insurer cannot have an actual expectation of receiving all contractual principal and interest of the underlying collateral as these tranches absorb the losses first for the securitization structure. Although cash flows may pass through to the residual holders at periodic intervals under the waterfall, ultimate returns depend on continued performance. Therefore, there can be no actual expectation that future payments will be received.

Along with the proposed P&P Manual language requiring residuals to be reported on Schedule BA, there is a proposed provision stating that for 2021 year-end reporting, residuals will be permitted on Schedule D-1 with an NAIC 6. If adopted, the SVO requests the Task Force's permission to remove that provision from the December 2022 version of the P&P Manual without further authorization as it will be an obsolete instruction.

Next year, the SVO would like to address additional items in the Working Group's referral with the Task Force regarding the meanings of NAIC 5GI and 6, namely:

- Clarifications to ensure that the NAIC 5GI self-assigned designation is permitted only for securities that could be reviewed for an NAIC designation if the documentation to support a credit analysis could be submitted.
- Clarification that self-assigning an NAIC 6* for securities that do not qualify for NAIC 5GI is not a declaration of potential default. Rather, the self-assignment indicates that the security could not be reviewed for a full credit analysis, and the requirements for an NAIC 5GI could not be met.

Mr. Cohen (KKR & Co. Inc.) asked about the definition of the "residual interest." For structured securities that are unrated at the tranche level but the securitization meets safe harbor rules modeling, should insurers expect to receive modeling results for those securities within the securitization? Eric Kolchinsky (NAIC) said there are a number of other limitations on what does and does not get modeled within the modeling process. Safe harbor is one of them, and the ability and model fit is another issue that is considered when modeling securities. Mr. Cohen said for single-asset, single-borrower commercial mortgage-backed securities (CMBS) transactions, where the securitization is backed by a single mortgage, these are ranging anywhere from 40% loan-to-value (LTV) to up to 75% LTV. The ratings designations are based on rating agency framework. In the cases of tranches that might be above a 60% LTV, there are not a lot of ratings on them and they are unrated, but they do receive contractual principal and interest. For these transactions that are not pool transactions, that are straightforward mortgage securitizations, the question is what should we expect to receive for modeling results. And if not, if capital designations can be provided for the rest of the capital structure, and there is a situation where an insurance company owns mezzanine debt that is junior to this tranche, can some type of designation framework be created? Mr. Therriault suggested taking the question offline because it is unrelated to the amendment the Task Force is considering.

Mr. Fry directed the SVO to expose the P&P Manual amendment to clarify proper reporting and designation for residual tranches and interests for a 15-day public comment period ending Dec. 2 so that the Task Force can consider it for adoption at the Fall National Meeting.

3. <u>Exposed a Proposed Technical Correction Amendment to the P&P Manual Clarifying 5GI Mapping to the NAIC Designation Category</u>

Mr. Fry said the next item is to receive and consider exposure of a technical correction amendment to the P&P Manual clarifying 5GI mapping to a designation category in the recently amended PL rating section.

Mr. Perlman said that during at the Task Force's May 24 meeting, it adopted an amendment to the P&P Manual requiring the submission of private rating letter rationale reports with certain private rating letters filed with the SVO. In the May amendment, certain language, which is currently in the printed December 2020 version of the P&P Manual and clarifies that an NAIC 5GI designation is the equivalent of an NAIC 5.B designation category, was mistakenly omitted. The SVO proposes a non-substantive technical amendment to the May amendment to reinsert the omitted language.

Mr. Fry directed the SVO to expose this non-substantive technical correction amendment to the P&P Manual to clarify the mapping of NAIC 5GI to a designation category for a 15-day public comment period ending Dec. 2 so that the Task Force can consider it for adoption at the Fall National Meeting.

4. Receive a Report From the SSG on the Year-End Process

Mr. Fry said the next agenda item is to receive a report from the Structured Securities Group (SSG) on the year-end process.

Mr. Kolchinsky said everyone should receive two files, one for legacy with breakpoints and one for non-legacy with designations. The year-end process is on time and should be delivered within normal schedule. The SSG has a lot of work to do next year. There are two main issues to deal with: 1) introduce new scenarios through the cycle. For residential mortgage-backed securities (RMBS), the SSG will draw from the same distribution that was done for the current year, and for CMBS, new scenarios will be introduced; and 2) there will be new mappings to map all 20 NAIC designation categories and 19 break points based on the new risk-based capital (RBC) factors. This will all go through the Task Force next year.
5.

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

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