VALUATION OF SECURITIES (E) TASK FORCE

Valuation of Securities (E) Task Force 2021 Spring National Meeting Minutes (Attachment One)
Valuation of Securities (E) Task Force June 9, 2022, interim Meeting Minutes (Attachment Two)

Draft Pending Adoption

Draft: 8/23/22

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

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

1. Adopted its June 9 and Spring National Meeting Minutes

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

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

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

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

Marc Perlman (NAIC) said the SVO has historically worked with statutory accounting colleagues to make accounting and reporting determinations, which guided whether the SVO could analyze and designate an insurer's investment. However, the P&P Manual currently provides conflicting guidance on whether the SVO should have a role interpreting accounting and reporting guidance. Paragraphs 32, 33, and 34 of Part One of the P&P Manual state that: 1) the assessment of an investment's credit risk is distinct from the determination of statutory accounting or reporting under the *Accounting Practices and Procedures Manual* (AP&P Manual); 2) accounting and reporting determinations for investments are the obligation of the insurance company, but state insurance regulators remain the final authority; and 3) the SVO may assign NAIC designations to any investment filed with it for which it has a methodology. However, it is also specified in Part One, paragraph 40 that the SVO is assigned to assess investments reported only on Schedules D and BA and shall communicate to insurers if an investment is

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

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

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

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

Chris Anderson (Anderson Insights LLC) said he hopes there would be symmetry between what the analyst at the SVO considers to be a bond and what will appear in the statutory accounting principles. Designations and credit ratings are expressions of the probability of payment on a scale of 1 to 20. If there is a probability of payment on a scale of 1 to 20, that indicates that the asset is a bond. It does not mean state insurance regulators should not have additional information about what kind of bond it is, but it seems that the most important element of investing in fixed income is whether there will be repayment. When the SVO or another analyst has expressed a considered view, reviewing all the facts and circumstances in an individual asset, it would seem to be compelling evidence. Mr. Anderson also hopes there will be coordination between the Task Force, the Statutory Accounting Principles (E) Working Group, and Capital Adequacy (E) Task Force.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

this time. Recognizing that this will likely be a multi-year project, state insurance regulators reserve the right to raise specific concerns that may arise as the various NAIC committee groups work to address this list of considerations.

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

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

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

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

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

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

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

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

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

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

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

Ms. Mears said the next item is to receive, discuss comments, and consider next steps on a proposal to add fixed income analytical measures for investments reported on Schedule D, Part One. This was first discussed at the Spring National Meeting and at the June 9 meeting. The proposed new fields will not only support the SVO's analytical processes, but they also align with the regulatory initiatives of the Capital Adequacy (E) Task Force, the

Life Actuarial (A) Task Force, and concerns expressed by the Financial Stability (E) Task Force and its Macroprudential (E) Working Group, which looks at industry-level and systemic risk, including their plans to build regulatory dashboards to reflect those risks. The commonly used bond analytical fields in this request are interconnected, one way or another, to the investment risk analysis being performed by these other regulatory groups and will ultimately benefit the NAIC by strengthening its overall regulatory framework. This request is not new and relates back to the 2010 recommendation from the Rating Agency (E) Working Group to look for an alternative way to measure risk, but its implementation is long overdue.

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

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

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

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

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

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

- Assisting in SVO identification of securities with CRP ratings, which may be inconsistent with a security's actual overall risk for NAIC purposes.
- Greater transparency for state insurance regulators into the risks and characteristics of insurer investments and portfolios.

- Incorporation of insurer investment portfolio analysis into the examination process.
- Allowing state insurance regulators to assess the capabilities of an insurer's investment management or risk management processes by reviewing the quality and accuracy of the market data fields.

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

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

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

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

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

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

Mr. Anderson said the objectives stated here are certainly laudable. The question is whether it is time now to decide which data needs to be assembled to accomplish those objectives. First, NAIC designations today are the same as nationally recognized statistical rating organization (NRSRO) ratings as they relate to credit risk, ability,

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

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

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

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

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

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

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

The SVO recommends exposing the definitional updates to Part Two of the P&P Manual, which include the new illustrations, and deferring the proposed Part Three instructions to remove securities with Other Non-Payment

Risks from FE. This deferral is intended to give industry sufficient time to provide examples of securities that are publicly rated by different CRPs, which have any of the three characteristics just listed for which there was not consensus, so the SVO can study them.

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

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

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

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

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

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

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

As for performance, the historical performance of CLOs has been good; this is especially true for the top of the capital stack. The recommended action is designed to allow insurers to continue participating in the CLO market without the risk that aggressive structuring puts policyholders and the investments in jeopardy. Given the performance of CLOs, some respondents commented that staff have not justified RBC at the 75% and 100% level. The current system works well if the intrinsic price is 70 or above since the highest RBC is currently 30%. A good

example comes from the 2008 financial crisis, where a mezzanine residential mortgage-backed securities (RMBS) tranche was evaluated with an intrinsic price of 5. The resulting RBC was far below the risk evaluated. This may also occur in the residual tranches, such as CLO equity, if cash flows are interrupted to protect senior tranches. There will be plenty of opportunity for commenting about modeling, and there will be plenty of opportunities to discuss the comments related to modeling, transparency, and methodology.

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

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

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

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

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

Mr. Carelus said the methodology paper for the CLO stress test was first published back in 2018 after the first time the stress was run. The SSG has run it every year since 2019 and 2020. The CLO stress test methodology paper is available on the NAIC website, under the Resource Center in the Capital Markets Bureau section. Ms. Mears said the CLO stress test methodology will be exposed with the materials on the Task Force web page.

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

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

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

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

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

12. Heard a Staff Update on the Ad Hoc CRP Study Group

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

13. Received an Update from the SSG on Modeling Scenarios

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

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

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

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

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-08-11 - Summer NM/Minutes/VOSTF 8.11.22 Summer NM Minutes.docx

Draft: 4/21/2022

Valuation of Securities (E) Task Force
Kansas City, Missouri
April 5, 2022

The Valuation of Securities (E) Task Force met in Kansas City, MO, April 5, 2022. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Scott A. White, Vice Chair, represented by Greg Chew and Doug Stolte (VA); Lori K. Wing-Heier represented by David Phifer (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kathy Belfi and Kenneth Cotrone (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Carolyn Morgan (FL); Dean L. Cameron represented by Eric Fletcher and Amber Re (ID); Dana Popish Severinghaus represented by Bruce Sartain (IL); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Melissa Gibson (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 and Justin Schrader (NE); Marlene Caride represented by Nakia Reid (NJ); Adrienne A. Harris represented by Bob Kasinow and Jim Everett (NY); Cassie Brown represented by Jamie Walker (TX); Jon Pike represented by Jake Garn (UT); Mike Kreidler represented by Steve Drutz (WA).

1. Adopted its 2021 Fall National Meeting Minutes

Mr. Chew made a motion, seconded by Ms. Doggett, to adopt the Task Force's Dec. 12, 2021, minutes (*see NAIC Proceedings – Fall 2021, Valuation of Securities (E) Task Force*). The motion passed unanimously.

2. Received and Discussed Comments on a Proposed Amendment to the P&P Manual to Update the Definition of PPS

Marc Perlman (NAIC) said that as explained at the 2021 Fall National Meeting, an amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) is being proposed to update the definition of "principal protected securities" (PPS) because the Securities Valuation Office (SVO) is seeing transactions that pose similar risks to PPS transactions, as currently defined, but they are structured in a way that do not cleanly fit that definition. Currently, the PPS definition covers securities with underlying assets. This includes a traditional bond or bonds and other "performance" assets, such as derivatives, common stock, commodities, equity indices, and even undisclosed assets, which are intended to generate excess return which are typically not securities that would otherwise be permitted on the bond schedule. In each case, the external credit rating provider (CRP) rating is based solely on the component dedicated to the repayment of principal and ignores the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1.

The SVO has received proposals for securities that possess many of the same risks as PPS but are structured in a way that they do not cleanly fit the definition in the P&P Manual. They could be described as "synthetic PPS" in that the security is not issued by an special purpose vehicle (SPV), which holds an "underlying" principal protection bond and the performance asset. Instead, the security is the direct obligation of a large financial institution, which is obligated to pay principal at maturity and a premium based on the performance of referenced assets, such as equity, fixed income or futures indices (or a combination thereof), and other financial assets. Though the obligation is solely that of the issuing financial institution, meaning there are no underlying bonds or performance assets (as currently specified in the PPS definition), the structure poses the same risk of exposure to a performance

asset because the amount of the issuer's payment obligation is directly dependent on the performance of the referenced indices or assets. Additionally, unlike a PPS transaction with an underlying bond and performance asset, the likelihood of payment of the performance asset premium, whatever the amount might be, is linked directly to the creditworthiness of the issuer.

Comments have been received from interested parties stating that they agree with the substance behind the proposed amendment but requested that the wording be thoroughly discussed, as was the case with the original PPS definition, to make certain that the amendment does what is intended and does not result in unintended consequences. The SVO requests from the Task Force permission to work with industry for purposes of modifying the language of the current proposal and then re-exposing this amendment for an abbreviated comment period. As deals of this type are currently coming to market, the SVO would like to expedite these discussions and the eventual adoption of this amendment.

Mike Reis (Northwestern Mutual on behalf of the American Council of Life Insurers [ACLI], Private Placement Investors Association [PPiA], and the North American Securities Valuation Association [NASVA]), said they understand the concern and support the change, but they would like to work with the SVO to avoid any unintended consequences.

Ms. Mears directed SVO staff to work with industry on technical modifications to the current proposed language and expose the revised amendment for a 30-day comment period.

3. <u>Exposed a Proposed Amendment to the P&P Manual to Update the Definition of Other Non-Payment Risks Assigned a Subscript "S"</u>

Charles Therriault (NAIC) said this agenda item is closely related to the last one in that PPS are a type of subscript "S" security. 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 clarified through additional illustrations securities that would also be considered as having "Other Non-Payment Risks." Based on comments received, The SVO requests the Task Force's approval to work with industry on modifying the language and fine-tuning the amendment to avoid any unintended consequences.

Mr. Reis said this is related to the previous item on PPS. There are more concerns with this amendment as to possible unintended consequences in the additional illustrations, and they appreciate working with the SVO to update the amendment and include a principle-based feature to avoid financial engineering.

Ms. Mears directed SVO staff to work with industry on technical modifications to the current proposed language and expose the revised amendment for a 45-day public comment.

4. Received and Discussed a Proposed Referral to the Blanks (E) Working Group to Add Fixed Income Analytical Risk Measures to Investments Reported on Schedule D, Part One

Mr. Therriault said the SVO proposes adding market-data analytical fields for bond investments to the annual statement instructions. This amendment is a first step towards what the former Rating Agency (E) Working Group recommended, and the Financial Condition (E) Committee approved, in 2010 to address lessening the NAIC's reliance on rating agency ratings by looking at other measures of risk. It also reflects the Investment Analysis Office (IAO) staff's recent findings regarding the discrepancies between ratings, presented in its Nov. 29, 2021, memo, and recommendation to identify securities with risks that may not be reflected by a rating.

The Rating Agency (E) Working Group made these summary recommendations in its April 28, 2010, report that was adopted by the Financial Condition (E) Committee:

1. Regulators [should] explore how reliance on Approved Ratings Organization (ARO) ratings can be reduced when evaluating new, structured, or alternative asset classes, particularly by introducing additional or alternative ways to measure risk.
2. Consider alternatives for regulators' assessment of insurers' investment risk, including expanding the role of the NAIC SVO.
3. When considering continuing the use of ratings in insurance regulation, the steps taken by the nationally recognized statistical rating organizations (NRSROs) in correcting the causes that led to recent rating shortfalls, including the NRSROs' efforts in implementing the recommended structural reforms, should be taken into account.

As the IAO staff demonstrated with the analysis in its Nov. 29, 2021, memo regarding rating discrepancies, not all CRP ratings reflect a reasonable or consistent assessment of a security's risk, indicating that rating shortfalls persist today. One step towards introducing alternative ways to measure a bond security's risk would be to require insurers to report various common analytical measures about each security, including metrics such as its current market yield, interest rate sensitivity, spread relative to risk-free securities such as U.S. Treasuries, duration, convexity, and average remaining life. The more a security's market yield and spread differ from similarly rated securities, the more likely it is that the implied market-perceived risk of that security differs from the risk indicated by the credit rating assigned to it. The yield difference or spread in basis points can potentially help identify securities whose CRP risk assessment warrants further review by the SVO, examiners, or other regulatory groups. For example, a AAA-rated 10-year security with a market yield of 6.00% appears anomalous when compared to data published by the St. Louis Fed (FRED) indicating a AAA U.S. corporate yield should be 3.00% (as of March 21). Significant differences would highlight a potential risk assessment mismatch. Other fields that measure a security's price sensitivity to interest rate movements may also help to identify market-perceived risk inconsistent with the assigned credit rating.

The Rating Agency (E) Working Group made similar recommendations to consider market data in its referral to this Task Force and the former SVO Initiatives (EX) Working Group. Their detailed recommendations were as follows:

1. Referral to the Valuation of Securities (E) Task Force: The Task Force should continue to develop independent analytical processes to assess investment risks. These mechanisms can be tailored to address unique regulatory concerns and should be developed for use either as supplements or alternatives to ratings, depending on the specific regulatory process under consideration.
2. Referral to the Valuation of Securities (E) Task Force: ARO ratings have a role in regulation. However, since ratings cannot be used to measure all the risks that a single investment or a mix of investments may represent in an insurer's portfolio, NAIC policy on the use of ARO ratings should be highly selective and incorporate both supplemental and alternative risk assessment benchmarks.
3. Referral to the former SVO Initiatives (EX) Working Group: The 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.*

The SVO is recommending the addition of these common bond market data fields to the annual statement instructions, through a referral to the Blanks (E) Working Group, for all bonds reported on Schedule D, Part 1 (those within scope of Statement of Statutory Principles (SSAP) No. 26R—Bonds and SSAP No. 43R—Loan-Backed and Structured Securities) with the objective of developing analytical processes to assess investment risk as either a supplement or alternative to ratings. To allow sufficient time for insurers to update their systems, the SVO recommends that the changes be implemented as electronic-only fields effective beginning with the reporting year ending Dec. 31, 2023. The SVO recommends informational referrals to the Capital Adequacy (E) Task Force and the Life Actuarial (A) Task Force to give them the opportunity to include any other market data fields that would assist them in their analysis work.

Ms. Mears said while the Task Force is proposing these new fields for the benefit of analytical procedures by the SVO, they really do align with other initiatives in place and with other groups, including the Capital Adequacy (E) Task Force and the Life Actuarial (A) Task Force. It is anticipated that will be a collaborative effort with those groups to ensure that the new fields are ones that can be used across those various work streams. She said this is a large change and that she agrees that insurers should be given sufficient time to prepare their systems. There are also changes coming from the bond project at the Statutory Accounting Principles (E) Working Group and will be working to align all those efforts across the various groups that are interested in this topic. These are all typical bond analytical fields commonly used to assess a bond risk, and they would be valuable information to be provided to state insurance regulators and the Task Force.

Chris Anderson (Anderson Insights) said what is being discussed is building a model and before a model is built, the purpose of the model needs to be understood. Is the model to get a general idea of insurers assets or is it to identify outliers or anomalies? Once that is addressed, the next question is what data elements are needed to populate the model? He said the suggestions seem reasonable. The question that needs to be addressed is: Are those the right variables? Are there too many, or are there not enough? If the purpose of the model is to identify outliers, then the right variables are needed. He said as another word of caution, if a simple web search is done, it will show how many people try to build models to identify what the proper rating agency rating should be. He said the world is littered with those Ph.D., artificial intelligence (AI), machine learning (ML) people. He said there are 5,000 analysts and supervisors at the nine rating agencies, and they would all love to have a model that would tell what the right rating should be for a bond. Mr. Anderson this is complicated and difficult, and perhaps the NAIC can find resources to build such a model. Before that is attempted, he said the model should be seen and

tested. Then decide whether thousands of companies should be required to provide additional data, especially because the model itself that the NAIC develops may not be work properly without additional data.

Mr. Anderson said that last year, 43 anomalies were identified. The tough part, then, is doing attribution. Why do those anomalies exist? He said it is unknown why the 43 anomalies identified last year exist. He said it is hard and difficult. Mr. Anderson said it could be that the NAIC would need to replicate the process of the rating agency. He said a medium size rating agency might have 70–75 methodologies. To replicate the rating, the methodologies need to be understood. For corporate, for example, the NAIC would need to come up with its economic scenario, rely on economists, and then get an industry assessment. If it is autos, if it is aviation, for example, it is important to know how the individual company fits into that structure, both the economic structure and the industry outlook. This is interactive, but the analysts, of course, are looking at history. They are looking at audited financial statements and other things, but they are also actively participating with the company. Rating agency analysts of a corporate issuer has inside information. They meet with the company. They follow the company. They perform their due diligence, and then they go to their committee, which is represented by specialists that are drawn from that industry and who can contribute to the conversation. The analysts' views are accepted or they are not, and the analysts just sent back for more work. Mr. Anderson that is the process the rating agencies go through. If there is an anomaly, it needs to be understood now what that anomaly is attributed to.

Mr. Anderson said the SVO has a different process. The SVO looks at history. It looks at three years of audited financials. It looks at secondary information. It looks at the report of the analyst at the insurance company to their investment committee. The SVO may look at other things, but it does not take advantage of the many things that the 5,000 analysts and supervisors at the nine rating agencies do. It is a different process. Even if the SVO had a model and it worked well, there would still be anomalies must be explained. He said that is going to be a challenge.

Mr. Anderson commented on the objective that that the NAIC should reduce reliance on rating agencies for the 315,000 securities that insurers own. He said the idea that the NAIC is trying to reduce reliance is probably not the appropriate objective for this group. That is a blueprint from a dozen years ago. Some of the working groups in that blueprint do not exist anymore. This is not excusing the rating agencies. He said the rating agencies historically did a terrible job a dozen years ago. The U.S. Securities and Exchange Commission (SEC) requires that methodologies and performance be published. The SEC is doing what the SEC does, shining a light on a problem. He said if look at Form NRSRO, you can see the nine exhibits for all the rating agencies in a form that is standardized. It is not only standardized, but the SEC investigates, and it makes sure that a rating agency says what it is doing and does what it says and then those are reported on annually.

Mr. Anderson said that what needs to be done with the R-1 and C-1 bond factors is to come up with reliable factors that can be used to drive the risk-based capital (RBC) model. The RBC model is complicated. He said there are probably not a lot of people who understand the intricacies of that model, but what the model requires is accurate default statistics. That should be the objective of this Task Force in coming up with accurate representations of credit worthiness for R-1 and C-1 that will allow the RBC model to achieve its objective, which is to identify potentially troubled companies. It may be that reducing reliance on rating agencies is something the NAIC winds up doing. In summary, there is the difficulty of developing a model and doing attribution when there are exceptions. The fundamental question of why it is not appropriate to be thinking about the benefit of having accurate C-1 and R-1 factors that drive the RBC model.

Stephen Broadie (American Property Casualty Insurance Association—APCIA) requested a 45-day exposure period for the proposal.

Ms. Mears directed SVO staff to expose this request for a 45-day comment period May 20 and to prepare a referral to the Blanks Working Group with copies to Capital Adequacy (E) Task Force and Life Actuarial (A) Task Force.

5. Received and Discussed Comments on a Proposed Amendment to the P&P Manual to Add Guidance on the Designation of Schedule BA Assets with Fixed Income Characteristics

Mr. Perlman 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 Manual 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 of the P&P Manual. Including the proposed provisions would enable the SVO to assign NAIC designations to Schedule BA assets that are not expressly covered by other sections of the P&P Manual (such as Schedule BA Funds). Schedule BA 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: "The SVO is assigned to assess investment securities reported to state regulators on Schedule D and Schedule BA." Additionally, the P&P Manual also explains in Part One 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 that currently are not. Each asset would need to be individually assessed by the SVO for bond or fixed income characteristics. At this time, the SVO recommends that SVO staff continue working with industry on this topic.

Mr. Reis said the ACLI, PPiA, and NASVA have had a longstanding shared goal with the SVO to work in getting NAIC designations on fixed income like instruments to right size the RBC charge. That will probably not happen without a referral to Capital Adequacy (E) Task Force. It also ties in with what is happening in the 43-R bond project with the Statutory Accounting Principles (E) Working Group, where certain investments may be moving to Schedule BA. Mr. Reis said this is a supported effort, and they will continue working with the SVO on it.

Ms. Mears directed SVO staff to continue to work with industry on the topic, which will eventually result in a referral to the Capital Adequacy (E) Working Group. She said it will be helpful, for their purposes, if there is a good framework that the Valuation of Securities (E) Task Force can provide to the Capital Adequacy (E) Task Force.

6. Adopted an Amendment to the P&P Manual to Permit Un-Guaranteed and Unrated Subsidiary Obligors in WCFI Transactions, with SVO Discretion

Ms. Mears said the Task Force has gone through several iterations of this amendment over the past year. With the current version, exposed at the 2021 Fall National Meeting, the SVO reintroduced 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.

Mr. Perlman said as the Task Force is probably aware of by now, the SVO received comments from certain insurers and other interested parties that it should assign NAIC designations to working capital finance investments (WCFI) with unguaranteed and unrated obligors, based on the implied support from an obligor's NAIC CRP-rated parent even though 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.

The current draft of the amendment, exposed at the 2021 Fall Nation Meeting, is substantially like the original amendment 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 that is lower than that of the parent based on its assessment of the parent/subsidiary relationship. However, this current 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 No. 105R—Working Capital Finance Investments*.

During the exposure period, a comment letter was sent to both this Task Force and the Statutory Accounting Principles (E) Working Group with comments related to working capital finance that go beyond the scope of the question of unrated subsidiaries and that affect SSAP No. 105R. It came to this Task Force's attention that the Financial Accounting Standards Board (FASB) exposure draft regarding disclosure of WCFI or supplier finance programs, as the FASB calls them, which was sent as an attachment to the letter, was not posted in the meeting materials, but it can now be found in the documents tab of the Task Force web page. The Statutory Accounting Principles (E) Working Group has indicated that it does not plan to address these comments at this time, and as such, the SVO proposes adopting this amendment in its current form and revisiting the other topics in question, depending on Working Group's position on them, should it revisit them in the future. If this amendment is adopted, SVO staff will monitor WCFI transactions and keep the Task Force informed if the SVO encounters any issues or has any problems with WCFI programs because of these new instructions.

Ms. Mears said this is a narrow application of this direction from the Task Force solely to these WCFIs. And as Mr. Perlman noted, the Task Force would anticipate, in a regulator-to-regulator session, a continued dialog with the SVO on what it is seeing and what types of investments are coming through in case the Task Force would like to alter this in the future.

Mike Monahan (ACLI) said that all the work on WCFI transactions is appreciated and that he agrees with the recommendation to adopt this amendment.

Mr. Kozak made a motion, second by Ms. Doggett, to adopt this P&P amendment by which the Task Force would direct the SVO to assign NAIC designations to WCFIs with unrated subsidiary obligors. The motion passed unanimously.

7. <u>Heard a Report on the Use of NAIC Designations by Other Jurisdictions in the Regulation of Insurers</u>

Mr. Therriault said the SVO was made aware of regulators or insurers in non-U.S. jurisdictions, such as the Bermuda Monetary Authority (BMA) and Japan's Financial Services Agency (FSA), either referencing NAIC designations in their regulatory processes or wanting to reference them. The P&P Manual is specific in 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 Manual says of the intended, proper, and authorized use of NAIC designations, 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 NRSROs 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.
5. NAIC designations and other analytical products of the SVO and Structured Securities Group (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.

The SVO received this request and support for this change from interested parties who have identified that some U.S. dollar private placement securities could be classified as "unrated" and receive unfavorable treatment if overseas regulators cannot rely on NAIC designations and different legal entities of a single parent could be subject to different capital charges.

Given this would directly affect an NAIC-owned work product and NAIC designations, and it will require the NAIC as an organization to enter into agreements with non-U.S. regulatory groups, the SVO believes the NAIC's Executive (EX) Committee will need to be involved and approve taking any further steps. The SVO recommends a referral to the Executive (EX) Committee for direction on how it would like to proceed with this matter.

Ms. Belfi said she has concerns about unintended consequences and the SVO being viewed as a rating agency. She asked if the ACLI could discuss what kinds of transactions are involved to require this support, then explain why it is important? She asked if it was maybe a U.S.-based group with a transaction with another jurisdiction, but there is concern with this blossoming into someone just wanting a rating from the SVO, and it has nothing to do with the U.S. group.

Mr. Monahan said this proposal is meant to address two jurisdictions, Japan FSA and the BMA, where U.S. dollar private placements are currently a core asset class for many U.S. companies operating in Japan, including MetLife, Prudential Financial, Aflac, Protective, and some other large companies. If these assets are considered undesignated after Japan adopts the International Associations of Insurance Supervisors' (IAIS') Insurance Capital Standard (ICS), there would be a huge selling pressure for an illiquid asset class, potentially causing market disruption on these U.S. assets. There would be no economic justification for this market's disruptive, just the inability of global regulators to reach agreement. This is a great opportunity for international regulatory cooperation that is primarily under any NAIC's control. Bermuda and Japan are extremely willing to use NAIC designations. Those jurisdictions just need to understand exactly what they need to do in a memorandum of understanding (MoU) to qualify for access. The NAIC can help by being very explicit about what Bermuda and Japan are going to use these designations for. They are U.S.-based groups.

Mr. Anderson said this undoubtedly has great merit. He said it is unfortunate when something is rated to not take that into consideration. But on the basic premise, just one observation, one will see in the last agenda item that the SVO designates, either on a first-time basis or on a repeat basis, about a little more than 12,000 securities a year. The notion that there is something special about any designation when the vast majority come from rating agencies is something that that need to be considered. He said he is not saying that this does not have tremendous merit; he said he was questioning the premise that there is a great difference between NAIC designations and rating agency ratings.

Ms. Mears directed SVO staff to forward this proposal to the Executive (EX) Committee requesting direction from it as to whether it supports the NAIC permitting non-U.S. jurisdictions access to and use of NAIC designations for their regulatory purposes if there is an MoU between the NAIC's governing that use and with an acknowledgement from the requesting regulator that its use of designations may deviate from the NAIC's intended purposes. She said the Executive (EX) Committee should also consider if guardrails are needed to ensure that usage aligns with the NAIC's expectations.

8. Heard a Report from the SVO on Carryover Filings

Mr. Therriault said as required in Part Two, Operational and Administrative Instructions Applicable to the SVO, of the P&P Manual, the SVO director must prepare a report for the Spring National Meeting identifying an acceptable annual rate of carryover filings for the year-end reporting period. These carryover filings can be identified with the administrative symbols "IF," which are initial filings with a self-assigned NAIC designation, and "YE," which are annual update filings the SVO has not yet reviewed, and the NAIC designation from the prior review was carried forward until the review is complete. There were 828 carryovers filing for 2021 versus 795 in 2020; 310 were "IF," and 518 were "YE." This represented a carryover rate of 6.7% for 2021 versus a carryover rate of 6.3% for 2020. Overall, the SVO reviewed 12,258 security filings for 2021. A carryover rate below 10% is manageable for the office given its current staffing. As of March 31, there were only 37 remaining carryover filings to review.

Mr. Therriault said the SVO continues to experience significant resource limitations regarding its technology support that is negatively affecting its ability to make significant or timely improvements to its core systems, VISION, Automated Valuation Service Plus (AVS+), and the Structured Security System (STS). There will be limited ability to intake the private letter (PL) rating rationale reports this year, and the full implementation of the policy in VISION will need to be deferred until 2023 or possibly longer. It has also prevented the SVO for several years now from being able to use the investment data it licenses, such as the business entity cross reference service and global instruments cross reference service. Both are necessary to implement investment organizational relationships and additional security identifiers like ISIN in these applications. He said any help that Task Force members can provide to increase the SVO's technology support is greatly appreciated.

Ms. Mears said the technology issues come up again and again and is something to be discussed at the Task Force in terms of what support it can provide moving forward with the SVO so that it can get the technology and other resources that they need.

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

Julie Gann (NAIC) said the Working Group met April 4. It addressed several issues during that meeting, but only five will be included in this update—two adoptions and three exposures. The meeting summary, items that were adopted, and those that were exposed are on the Working Group's web page. The Working Group adopted a proposal to support new reporting related to cryptocurrency. Although it did not result in any actual statutory revisions, it did support a new general interrogatory, which is up for adoption at Blanks (E) Working Group in May and will be in effect for a year in 2022. The disclosure will capture information from reporting entities on their use of cryptocurrency, if they hold it, what reporting schedule it is on, and if they are receiving cryptocurrency as payment of premium.

The second adoption relates to SSAP No. 43R; the Working Group adopted revisions that were referred from this Task Force related to financial modeling. The Working Group considered whether to remove the financial

modeling guidance from the SSAP fully or just point to the P&P Manual. After considering comments from industry, the Working Group decided to retain the guidance in SSAP No. 43R. However, it was identified that it was easier for preparers to refer to the summary there, but the Working Group did make a point to comment during the meeting that it is only a summary, and the detailed guidance is in the P&P Manual, if there is a need to get to the actual detailed level guidance.

For exposures and discussion items, Ms. Gann said there three things to note. First, for the principles-based bond project, the Working Group exposed a revised bond definition, as well as a draft issue paper in March. The Working Group noted that comments are due May 6. The Working Group received information through comments received from industry on the proposed reporting changes. As Ms. Mears mentioned earlier, the Working Group expects significant reporting changes to Schedule D-1, as well as other satellite schedules, as a result of this project. The Working Group wants to make sure it communicates that loud and clear so that no one is unaware when those changes are in effect. NAIC staff were directed at the Spring National Meeting to continue working with industry on those reporting changes, as well as to draft SSAP revisions so the bond definition gets reflected in SSAP No. 26R and SSAP No. 43R, and then those would be subsequently exposed for comment. The goal is to have more granularity and transparency on the investments that are held on Schedule D-1. She said it is a big project and if anyone wants to talk with NAIC staff to get more information, they can reach out and talk to her.

With regards to another item that was up for exposure, the Working Group discussed reporting changes to identify whether an investment is with a related party, regardless of whether that investment is identified as an affiliated investment in the reporting schedule. This is a second exposure related to this item, where the Working Group reflected some interested party comments and re-exposed it for a shortened comment period that ends on May 6. The goal is to have it in effect for year-end 2022. There is a concurrent Blanks (E) Working Group proposal that was also exposed. There will be new electronic reporting columns for reporting entities that would identify a code on whether the investment came through a related party. There are five different codes there. One is for direct credit underlying credit exposure and if there was a related party otherwise involved as a service or manager again.

Lastly, Ms. Gann said the Working Group exposed a draft interpretation (INT) related to new securities that are referred to as When Issued Freddie Mac Securities. For that investment on day one, the reporting entity acquires a certificate that is backed by cash flows held in a trust. There is a subsequent trust that acquires the mortgage-backed securities within 90 days; it is like a double pass-through. The exposed INT identifies that these securities would be within scope of SSAP No. 43R at the date of acquisition. There would not be any moving between schedules. The securities are guaranteed by Freddie Mac. This was exposed for comment with a shortened comment period deadline of May 6, to get the INT in place.

10. <u>Heard an Update on New RMBS/CMBS Thresholds and Price Breakpoints</u>

Ms. Mears said the next item is to hear an update on new residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) thresholds and price breakpoints.

Eric Kolchinsky (NAIC) said the SSG's plan for the price break-point is to apply the current methodology using the new RBC factor targets for the thresholds and designations. SSG staff will follow the same approach that it currently uses for credit risk transfer (CRT) securities, and those are based on the breakpoint approach. This will be released through the Task Force for comment. SSG staff are closely working with the vendor, BlackRock Solutions, on the scenarios as well and hope to release those scenarios shortly, but it does require a lot more

work. The release will include the scenarios and the associated probability. He said SSG staff look forward to getting feedback on them and having a robust discussion with both regulators and industry on these scenarios.

11. Received an Update on the Ad Hoc Study Group

Mr. Therriault said the ad hoc group—consisting of regulators, insurers, and NAIC staff—met for the first time on March 11 to discuss objectives for the group:

- Establish a framework of qualitative and quantitative criteria for being a CRP to the NAIC.
- Eliminate/minimize RBC arbitrage opportunities between CRP ratings and asset classes.
- Define a repeatable quantitative process to evaluate rating performance for all rating agencies consistent with NAIC RBC factors.
- Incorporate market data to help identify potential misalignments of risk, as recommended by the former Rating Agency (E) Working Group in 2010.

The ad hoc group also discussed the mapping analysis framework that one rating agency uses to map other rating agency ratings to their rating scale. The ad hoc group plans to meet again after the Spring National Meeting and is currently scheduled to meet monthly thereafter.

Ms. Mears said she anticipates the ad hoc group will have more robust updates once it has more than one meeting under its belt.

12. Discussed Other Matters

Mr. Kolchinsky said that there will be a joint NAIC and industry discussion on infrastructure that will be held immediately following Task Force meeting. It covers a report on infrastructure that was jointly written by the Capital Markets Bureau (CMB) and Center for Insurance Policy and Research (CIPR).

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-08-11 - Summer NM/01 - Minutes/VOSTF 4.5.2022 Spring NM (Final)v2ReflectingSummerNMEdit.docx

Draft: 7/13/22

Valuation of Securities (E) Task Force
Virtual Meeting
June 9, 2022

The Valuation of Securities (E) Task Force met June 9, 2022. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Scott A. White, Vice Chair, represented by Doug Stolte (VA); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Carolyn Morgan (FL); Dean L. Cameron represented by Eric Fletcher (ID); Dana Popish Severinghaus represented by Vincent Tsang (IL); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Kathleen A. Birrane represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Eric Dunning represented by Lindsay Crawford (NE); Marlene Caride represented by John Sirovetz (NJ); Adrienne A. Harris represented by Jim Everett (NY); Cassie Brown represented by Amy Garcia (TX); Mike Kreidler represented by Tim Hayes (WA).

1. Received and Discussed a Memorandum of Support from the Financial Condition (E) Committee to the Task Force

Ms. Mears said the first item on the agenda is to receive and discuss a memorandum of support from the Financial Condition (E) Committee to the Valuation of Securities (E) Task Force, the Capital Adequacy (E) Task Force, the Statutory Accounting Principles (E) Working Group, the Life Insurance and Annuities (A) Committee, and other regulatory groups and interested parties. The purpose of the memo was to express support for several interrelated initiatives focused on asset risk that are underway by the Valuation of Securities (E) Task Force as well as other committees, task forces, and working groups. The Financial Condition (E) Committee recognized that there is a range of risk management practices across the industry, but it highlighted the importance of "… establishing standards if necessary to address issues that could translate into material risk if not properly and timely considered within the NAIC solvency framework." The Committee highlighted the Task Force's work on the use of or reduction of reliance on rating agencies and the use of other risk identifiers such as market data, which are two agenda items today. This memo was received and supports the work of the Task Force.

2. Received and Discussed Comments on a Proposed Referral to the Blanks (E) Working Group to Add Fixed Income Analytical Risk Measures to Investments Reported on Schedule D, Part One

Ms. Mears said the next agenda item is to receive and discuss comments on a proposed referral to the Blanks (E) Working Group to add fixed income analytical risk measures to investments reported on Schedule D, Part One. As noted on the memo, it is important to establish standards necessary to address issues that could translate into material risks. This request is not necessarily new, and it relates back to a 2010 recommendation from the Rating Agency (E) Working Group that looked at alternative ways to measure risk. As per the comment letters, there are concerns from a few areas, one being the operational burden of collecting this data for reporting on Schedule D, which is something that can be discussed. There were a few other notes as well that there may be reasons those investments have outperforming spreads or yields that may not be related to credit risk. This is one that is important to note, because while this was brought up in relation to the review of credit ratings, there may be a sense that the credit rating itself should be looked at if there are spreads that are outsized compared to comparable assets. It is also something that helps note that there are other risks that can support those extra returns. It may not necessarily be reflected in the framework right now, such as liquidity or complexity. In that

case, it may not be looking to the credit rating itself, but the ability to review the framework must still be available so it is encompassing all measures of both returns and risk in a holistic way. That is ultimately the information that is to be gathered to continue the transparency into these portfolios. Most note that it is not a world of just buy and hold very traditional assets through maturity within the industry, but rather investments are actively traded and managed through times of stress or a recessionary environment. There are multiple reasons for this market value data, and it will be very valuable. It is important to be aware that it is not just for one particular purpose, but it is more broadly reflective of how to see portfolios being managed today.

Charles Therriault (NAIC) said the Securities Valuation Office (SVO) views this proposal as a vital step in achieving two of the primary and long outstanding goals of the Rating Agency (E) Working Group that were referenced in the paper: 1) developing additional or alternative ways to measure risk; and 2) using those risk measures to lessen the NAIC's reliance on rating agency ratings. These common bond analytical fields can be used for a variety of other regulatory purposes, such as identification of risk, valuation assessment, interest rate sensitivity, cash flow life, and NAIC designation validation. Any changes to assumptions or cash flow expectations after purchase will be picked up by these measures. The yield on an investment cannot be changed without also changing the market price of that security. These metrics are an easy way to identify where the insurer or market perceives the overall risk level for an investment of a given quality level. There may be several other sources of risk that are driving a yield spread; but it is still a very useful tool. SVO staff strongly support getting this information and looking at the different means by which to operationalize it.

Ms. Mears said three comments letters were received: 1) a joint comment letter from the American Council of Life Insurers (ACLI), the Private Placement Investors Association (PPiA), and the North American Securities Valuation Association (NASVA); 2) a letter from the Lease-Backed Securities Working Group; and 3) a comment letter from Anderson Insights.

Mike Reis (Northwestern Mutual), on behalf of the ACLI, the PPiA, and the NASVA, said industry wants to provide meaningful data to the state insurance regulators. The concern was that the effort to supply the data from each individual company would not be inconsequential. Industry wants to prevent adopting it as is and finding out later that that it did not hit the nail on the head with providing the proper data. Industry wants to work with the state insurance regulators and the SVO to think of the best way to achieve the ends that are important to state insurance regulators, whether that is centrally aggregating it, filing through the VISION system, or whatever other means that is most efficient to get the data to the state insurance regulators. For example, 75% of asset-backed securities (ABS) do not rely on rating agencies; if you add collateralized loan obligations (CLO), which is later on the agenda, to the commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS), that would all be modeled by the NAIC. Much of the public market data is either publicly available or available through the U.S. Department of the Treasury (Treasury Department) or other similar securities where such data is not relevant. The most efficient way to do it must be found so it is not a burdensome expense without the requisite bang for the buck.

John Garrison (Lease-Backed Securities Working Group) said the main point of the letter was to alert state insurance regulators that there could be a number of issues, particularly when it comes to applying public bond spreads or prices as an indicator for the credit rating when applied to private investments, for which there are many more factors that could influence pricing.

Chris Anderson (Anderson Insights) said it is now possible with some creativity, even on a personal computer, for an analyst to start working with the data that is available. Some may have to be calculated, some frameworks can be created and what exists can be operationalized. There is generally no substitute for getting your hands dirty

starting on something, and it has the potential for avoiding false starts. It has a potential for assuring that the data that is sought for thousands of companies is the data that will be helpful. Another element is to distinguish between C-1, R-1, credit risk, and other investment risks. C-1 and R-1, credit risk, is something that is derived from credit analysis, which is what the SVO and credit agencies do. The NAIC relies substantially on the thousands of credit analysts working at the nationally recognized statistical ratings organization (NRSRO) that it recognizes. There is every reason to evaluate those credit ratings and ensure they are of a quality that is sufficient to support the calculation of risk-based capital (RBC) because R-1 and C-1 are just credit risk. That is one objective to ensure there is reasonable quality of rating agency ratings in SVO designations. The other question is of not just credit risk, but investment risk; credit risk is a subset of investment risk. There are many other elements of risk that will affect spreads, and the difficult element here is to not just say that spreads are wide, but to do an assessment and evaluation and attribute the reason for the widespread. State insurance regulators need to know that. Just knowing that the spread is wide is interesting, but with hundreds of thousands of securities, it would be very helpful to understand if there is complexity, because an examiner might then want to go in and look at the companies' analytics; Or if it is liquidity, then an examiner might want to look at liquidity. What is addressed in the letter is doing an analysis of attribution and the work that is being done in attribution. The CFA Institute just offered a 12-hour program to do that. Getting back to the core point, assessing the reliability of rating agencies is one project that can be undertaken. The second is more complicated; i.e., not just looking at spreads but giving state insurance regulators the information they need as to why those spreads may be wide.

Ms. Mears encouraged everyone to follow all the committees and groups that were referenced in the Financial Condition (E) Committee letter, because it points to the interconnectivity between the outcomes and the data that would be utilized to review the overall regulatory framework. There was a conference call of the Life Actuarial (A) Task Force that spoke to some of the key elements that Mr. Anderson was referring to, including attribution of spread and some more higher yielding assets in comparison to other assets of similar credit rating. The regulatory framework is built very much around credit risk and using the inputs from the NAIC designations, whether they come from a credit rating provider (CRP) or other sources for NAIC designations, and it measures the overall risk of an investment. Historically, that really was enough. Other sources that contributed to that return were less material in relation to the credit risk component. As there is a gain in materiality, to the points that were made here, it really helps from a regulatory standpoint to have some transparency into what the components are and then review the regulatory framework accordingly.

There is absolutely the understanding that all of those will not necessarily be measured by credit risk, but currently, that is the input. These efforts are not only helpful to the Valuation of Securities (E) Task Force, but they can contribute to the analysis being done across the board from all these other initiatives as well. For example, looking from an industry-wide perspective, the NAIC is building out capabilities within the Macroprudential (E) Working Group to look at more industry-level risks and systemic risks and looking at dashboards to reflect those risks. That would be another forum where a lot of this data could be aggregated from a market basis and utilized for establishing perspective even from an industry-wide standpoint. From that perspective, the comments made are very much heard and understood, and they really help support looking at this on a more holistic basis. The operational difficulties of getting this reported on Schedule D are being heard along with some intriguing ways to do that outside of the statutory reporting process, including using other platforms like Bloomberg or Aladdin. This is a great opportunity from an SVO standpoint to take a step back and look at the capabilities and investment infrastructure at the SVO and how it can be pulled together to help achieve some of these initiatives across the board that were laid out in the Committee letter.

Mr. Everett said the project started with the discussion of the reduction of reliance on rating agencies. The Rating Agency (E) Working Group called not only for substituting items, but also looking to complementary sources of

credit information. This was to stay within the credit gambit. These included multivariate accounting-based credit scoring that could be tied back into the Statutory Accounting Practices (E) Working Group since they are accounting based. Other methodologies like contingent claims valuation methodologies or imputed promises methodologies; certification and endorsement regimes like the European Securities and Markets Association (ESMA); central credit registers, which were closed at the time but are more accessible; and central financial statement databases, which are substantially more open than they had been. Regarding some of the proposals, while a lot of the items being called for would cover small yield changes or over the short-run and parallel yield curve shifts, more might be needed to cover for stress situations where the curves do not move parallel. Without going into the attribution side, it might be possible to use something like the Sortino ratio as a screening device because it has been widely tested and verified across industries and market periods. It is elementary and easy to apply that, as departmental analysts and examiners could be able to use it. It can be used for even highly concentrated portfolios, such as commercial real estate holdings or CLOs and large portfolios. Subsequent testing has shown that it can be used for smaller ones. The Sortino ratio is a variation of the Sharpe ratio. That differentiates harmful volatility from total overall volatility by using the asset's standard deviation of negative portfolio returns. It is sort of a Sharpe ratio, but it came to mind since the concern seems to be with downside volatility, and it takes an asset or portfolio's return, subtracts the risk-free rate, and then divides the amount by the asset's downside deviation. This could be a screening device. There are other complementary sources of credit information that were considered, and while they were not mentioned expressly in the Rating Agency (E) Working Group's report, they were talked about in that the Bank for International Settlements (BIS) said it had given great credit to those.

Ms. Mears said as the Task Force takes a step back here to look at operationalizing this, it can continue to look at what type of data and metrics can be utilized as well. She recommended that this work continue and that the Task Force work with industry on their ideas, as well in a collaborative effort to obtain these types of information that are market value-based metrics, including ways that make sense both from the list from industry, but also from the SVO, that might result in some questioning and modernize some of the processes at the SVO to accommodate that.

3. Received a Proposed Amendment to the P&P Manual to Update the Role of the SVO Regarding Interpreting Accounting and Reporting

Marc Perlman (NAIC) said the SVO has historically worked with the NAIC's statutory accounting colleagues to make accounting and reporting determinations, which guided whether the SVO could analyze and designate an insurer's investment. However, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) currently provides conflicting guidance on whether the SVO should have a role in interpreting accounting and reporting guidance. While many sections of the P&P Manual state that the SVO may assign NAIC designations to any investment filed with it for which it has a methodology, it also specifies in Part One, paragraph 40 that the SVO is assigned to assess investments reported on Schedules D and BA and shall communicate to insurers if an investment is not eligible for those schedules and can therefore not be assigned an NAIC designation. Part One, paragraph 32 of the P&P Manual explains that the assessment of an investment's credit risk is distinct from the determination of statutory accounting or reporting under the *Accounting Practices and Procedures Manual* (AP&P); i.e., obtaining an NAIC designation does not change an investment's applicable statement of statutory accounting principles (SSAP) annual or quarterly statement reporting schedule, nor does it override other SSAP guidance required for the investment to be an admitted asset.

Paragraph 33 of the P&P Manual explains that accounting and reporting determinations for investments are the obligation of the insurance company, but the state insurance regulators remain the final authority.

Paragraph 34 of the P&P Manual expressly states that the SVO can assess any investment filed with it, so long as it has the methodologies to do so. Because SVO analytical determinations of credit quality do not convey opinions, conclusions, or informational content relative to statutory accounting status, the SVO may assign an NAIC designation to any obligation or asset that is filed by an insurer, provided that its credit quality can be assessed consistently with the polices and methodologies specified in the P&P Manual.

However, Part One, paragraph 40 of the P&P Manual states that the SVO is only assigned to assess investments reported on Schedules D and BA, and it may need to communicate to insurers that the investment is not eligible for reporting on Schedules D or BA; therefore the investment cannot be assigned an NAIC designation.

The SVO is assigned to assess investment securities reported to state insurance regulators on Schedules D and BA. To fulfill its function, the SVO must be able to communicate to an insurer that has filed a financial instrument or security that the financial instrument or security is not an investment security eligible for reporting on Schedules D and BA. The SVO may be required to communicate to an insurer that it must refile a financial instrument or security to another schedule. The SVO may also have to communicate to an insurer that an instrument the insurer has filed does not meet the definition of an investment security in the P&P Manual and is therefore not eligible to be assessed.

The SVO recommends amending Part One, paragraph 40 of the P&P Manual to provide consistent instructions to the SVO regarding its accounting and reporting guidance authority. The proposal would clarify, in accordance with Part One, paragraph 34, that the SVO can assign NAIC designations to investments that it does not think are eligible for Schedules D or BA reporting, so long as it has the methodology to do so. However, the SVO would have the authority, at its discretion, to notify the appropriate state insurance regulators of any investments that, in its opinion, would not or might not be eligible for reporting on Schedules D or BA. The SVO would also maintain its authority to offer its accounting and reporting opinion, when requested to do so, as part of its Regulatory Treatment Analysis Service (RTAS), it being understood that such opinions would not be authoritative and might not reflect the opinion of the relevant state insurance regulator. Also, to be clear, the SVO would not be required to designate investments that deviate from specific guidelines in the P&P Manual for that investment type. For example, for the SVO to designate a working capital finance investment (WCFI), the investment will still need to meet the very specific WCFI guidelines currently in the P&P Manual.

Mr. Reis said the ACLI had a meeting today, discussed this proposal, and asked if this proposal will be exposed. Ms. Mears said it will be exposed.

Mr. Anderson said anytime there is clarification in the P&P Manual is a good thing. Something mentioned earlier is coordinating between groups. One interested group here is the Risk-Based Capital Investment Risk and Evaluation (E) Working Group. Mr. Anderson said there is a little bit of tension here in his mind because the NAIC says something is not a bond and does not qualify for the bond schedule. On the other hand, there is a proposal to assign RBC factors—i.e., credit risk factors—which are bond factors and based on bonds and credit. It would be appropriate sooner rather than later, but preferably before any changes are made to ensure there is coordination with the Working Group.

Ms. Mears directed staff to expose this proposed amendment for a 30-day public comment period.

4. Received a Proposed Amendment to the P&P Manual to Update Part Four for NAIC Designation Category and Additional Price Points

Ms. Mears said the next agenda item is to receive a proposed amendment to the P&P Manual to update Part Four for NAIC Designation Category and Additional Price Points. The Task Force and the Structured Securities Group (SSG) have discussed these anticipated changes several times over the past year, including at the 2021 Summer National Meeting, the subsequent interim meetings, and again at the 2022 Spring National Meeting.

Eric Kolchinsky (NAIC) said last year, the SSG did not fully implement all 20 new NAIC designation categories. It was known that it was going to take longer to do this for modeled RMBS and CMBS. Temporary language was added to the P&P Manual until new price ranges were developed to reflect the full range of RBC factors adopted for each NAIC category. This has now essentially been completed, and Mr. Kolchinsky wants to reflect it in the P&P Manual. The changes are to the categories, as can be seen in the markup of the P&P Manual, to reflect shifting away from six to 19 breakpoints and changing the language in Part Four, paragraph 27 regarding some of the temporary language. The intention is to proceed with the procedure for deriving the midpoint, as has been done before; that is the midpoint for the two categories. The intention is, outside of the change in the risk-based factors, to maintain status quo procedurally. The SSG recommends the exposure and then adoption of these new breakpoint factors.

Ms. Mears directed staff to expose this proposed amendment for a 30-day comment period and will discuss it at the Summer National Meeting.

5. Received and Discussed an IAO Issue Paper on the Risk Assessment of Structured Securities – CLOs

Ms. Mears said the next item on the agenda is to receive and discuss and Investment Analysis Office issue paper on risk assessment of structured securities, specifically CLOs. The IAO has identified large RBC arbitrage opportunities and incentives with these structures.

Mr. Kolchinsky said CLOs have been a topic of a lot of conversations and one of the things that the SSG has found within the structure of CLOs is the great potential for risk arbitrage. If you take a pool of assets with effectively a single "B" rating, put it in a CLO and calculate the total RBC on every single tranche of the CLO when it is produced, there is a huge amount of regulatory arbitrage. The risk weighting is reduced by about two-thirds. This is an issue, and Mr. Kolchinsky is making two recommendations: 1) the Task Force should direct the NAIC to promote modeling CLOs; and 2) the Task Force should direct referrals to the Capital Adequacy (E) Task Force and the Risk-Based Capital Investment Risk and Evaluation (E) Working Group requesting that those groups consider creating or breaking out the NAIC 6 Designation into three designation categories; i.e., 6. A, 6.B, and 6.C. That would allow the SSG to capture some of the tail risk in these securities through weights in the middle. It is not expected that many securities will fall in there, but in case there are tail risks to equalize the RBC, it would be helpful to have 30%, 75%, and 100%. The modeling would be based off the current CLO stress test methodology. Currently, scenarios and probabilities have not been set, and the SSG will come up with eight to 12 scenarios. The scenarios would probably be various combinations of default rates and recovery stresses. The idea that they would arrive at probabilities by trying to balance the total risk on the assets within the risk of tranches. This would be a risk-based approach. The tranches can be a little convex within a set of thresholds. This process would be completely transparent and could do it periodically if something changes. It would be a de-arbitrage approach and do something like what the SSG does for RMBS and CMBS, provide this on an annual basis, and publish via AVS+ or a similar system.

Mr. Tsang said there are many structured assets. He asked if a system must be come up with to unionize this arbitration and how this will be accomplished. Mr. Kolchinsky said this would just be for CLOs in terms of the risk

arbitrage; although, in the past, the Valuation of Securities (E) Task Force has been pretty responsive to changes like RMBS and CMBS. There are now concerns about CLOs, which is about three-quarters of the structure finance market or at least the credit sensitive part of the structure finance market. If the Task Force determines another issue or another part of the market where there is an issue, that is something the SSG can look at as well. The recommendation in terms of internal modeling is solely for CLOs, at this time.

Mr. Tsang said he supports the initiative, but the work is overwhelming. Mr. Kolchinsky said the SSG has been running stress scenarios for the CLO universe for three years. The SSG has a lot of ex-CLO people in the New York office. This will not be a huge endeavor. Other asset classes, such as auto floor plan loans, would require further research, but the SSG can certainly do CLOs.

Mr. Tsang asked if the insurer needs to look up a table or database to recognize this arbitration adjustment. Mr. Kolchinsky said the methodology approach would be done just like it is for RMBS and CMBS today. The insurer would go to the website for the AVS+; download the designations or break points, as appropriate; and determine how to report their tranche. The insurer would not have to do anything more than they do today for RMBS and CMBS.

Mr. Anderson said setting RBC factors is the domain of the Capital Adequacy (E) Task Force. He asked if this will be referred to the Risk-Based Capital Investment Risk and Evaluation (E) Working Group.

Ms. Mears said this will involve referrals to those groups. That will be a discussion of whether it currently calibrates to the existing bond factors like what is in place for CMBS/RMBS. There is discussion underway in the Working Group about whether a new set of factors is needed for structured securities. If that is decided within the Working Group, then this process should go forward and adjust accordingly to reflect that and calibrate to those factors. The overall modeling would not change. It would be the mapping process that would occur to the factors that are defined by the Working Group. All these initiatives are a multi-group process. It is important to get some preliminary feedback on the concept and suggest that staff expose this issue paper for a 30-day public comment period. Ms. Mears said she would recommend that staff move forward with drafting the amendment and work through what that process would look like. The comments may be more questions on specifics of how to move forward to keep that process moving. Ms. Mears said formal comments are welcome during the 30-day public comment period, but if there are any informal comments that want to be shared during that time as the amendment is drafted, staff can feel free to share those. That would include the referral, as well as to both the Capital Adequacy (E) Task Force and Risk-Based Capital Investment Risk and Evaluation (E) Working Group.

6. Heard a Presentation from the SSG on Modeling and Scenarios

Ms. Mears said the next item on the agenda is to receive a presentation from the SSG on modeling scenarios.

Mr. Kolchinsky said these are the macroeconomic scenarios for RMBS and CMBS. The SSG is proposing moving from the current four to eight scenarios. Now that that there are 20 designation categories, the SSG wants more differentiation among the securities. The idea here is not to change the balance of a risk but to differentiate between the various tranches. These proposed scenarios are meant to be through-the-cycle. The probabilities have not been finalized for each but will be lowering the probabilities at the tail and increasing the probabilities in the belly of the distribution. For CMBS, there are three scenarios between the old scenarios and an added tale scenario. It is not too different from the shape in the past to differentiate. These are based on the simulation that was run and the numbers that were exposed in the past. For RMBS, three scenarios were added in between the older scenarios, and a tail scenario was added. RMBS probabilities are still being optimized. The goal is not to

increase or decrease capital but to differentiate. The stress scenario does not need to be so large because it is covered by more extreme scenarios in the tail scenarios. These should be completed shortly once the fine tuning is done. These are the SSG's thoughts for the year-end scenarios and are meant to be through-the-cycle and will not be changing from year to year.

Mr. Tsang asked what NPI and HPI are. Mr. Kolchinsky said HPI is a home price index, Case Shiller, a national measure of home prices and the way the RMBS scenarios have been benchmarked. CMBS has a similar measure called the National Price Index for commercial real estate. The tables and charts are identical in terms of form to what is normally produced for the annual year-end scenario disclosure.

Francisco Paez (MetLife) asked if the SSG plans to do a sampling year for year-end 2022 so industry could do a little bit more comparison of how this change would affect capital versus 2021.

Mr. Kolchinsky said the SSG is working on it and hopes to provide it so people can compare and look at what the impact is around the mid-year September/October timeframe.

Mr. Tsang said there is speculation of a recession this year or next. He asked if Mr. Kolchinsky believes a tail would cover that. Mr. Kolchinsky said he believes the tail is much worse than the global financial crisis in terms of the change in price. The tail covers scenarios like the potential recession. While these scenarios are future looking, a lot of results are driven about the performance in the current portfolio. Loans will go delinquent or go special servicing, which will be reflected. This is just a question of what will happen in the future, starting from a time of running the scenarios so it does not completely take us out if there is underperforming or well-performing, which will be reflected in the current portfolio starting point. These are just forward-looking scenarios and economic scenarios.

Mr. Tsang said he is looking at the slides and tables for the HPI and the NPI. If a column could be added with the probability estimate that would give the reader a little bit more appreciation of probabilities that will run into this kind of thing. Otherwise, there is no way to know which one would be more likely than the others.

Mr. Kolchinsky said the SSG will get back with the probabilities assigned to each one, and they will be part of the public disclosure in a few weeks.

7. Discussed Other Matters

Ms. Mears asked Mr. Therriault to give a brief update on the Ad Hoc CRP Group's work.

Mr. Therriault said the Ad Hoc CRP Group has been meeting monthly to discuss several issues related to the use of ratings. At the last meeting, it discussed possible changes to the definition of an NAIC designation in Part Two to better align it to the definition in Part One. The definition in Part One includes whether there is an appropriateness and consistency of the RBC model factor for the designation assigned. Part Two does not mention that. The Ad Hoc CRP Group is also discussing the SVO Notching Guidelines in Part Two and the possibility of adding a definition of a default to clarify the notching process. There will be a meeting later this month where the Ad Hoc CRP Group plans to discuss possible qualitative factors for CRPs. Any output or recommendations from the Ad Hoc CRP Group, because it is informal, will come before the Task Force to be publicly exposed and fully discussed with all parties.

Ms. Mears said the Ad Hoc CRP Group continues to work through the high-level setting of some of the workstreams to move forward and where to prioritize. This framework will continue to be built out, so that is very repeatable and something that can be kept in place over time. As new providers enter the market, they would be subject to the same framework. It communicates what the Task Force's expectations are to CRPs but will ultimately be agnostic to the CRPs that exist. It is anticipated that all the existing CRPs would go through this process. What that process will look like is not yet known, but as the Ad Hoc CROP Group continues to work down that route, it will be fully transparent and discuss among itself and other stakeholders before anything is implemented. It is expected to be a fairly long process, and any continued questions are welcome, but Ms. Mears said she will report back when there is something firm to share.

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-08-11 - Summer National Meeting/01 - Minutes/VOSTF 6.9.2022 Minutes (Final).docx