Draft Pending Adoption

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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. <u>Adopted its June 9 and Spring National Meeting Minutes</u>

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

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

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. <u>Discussed Comments and Adopted a Proposed Amendment to the P&P Manual to Update the Definition of PPS</u>

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. <u>Discussed, Received Comments, and Exposed the Proposed Task Force Charges for 2023</u>

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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.

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