VALUATION OF SECURITIES (E) TASK FORCE

Draft: 8/28/23

Valuation of Securities (E) Task Force
Seattle, Washington
August 14, 2023

The Valuation of Securities (E) Task Force met in Seattle, WA, Aug. 14, 2023. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Eric Dunning, Vice Chair, represented by Lindsay Crawford and Nolan Beal (NE); Lori K. Wing-Heier represented by David Phifer (AK); Mark Fowler represented by Sheila Travis (AL); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone and Wanchin Chou (CT); Michael Yaworsky represented by Carolyn Morgan and Bradley Trim (FL); Dean L. Cameron represented by Eric Fletcher (ID); Dana Popish Severinghaus represented by Vincent Tsang (IL); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak and Lynn Beckner (MD); Grace Arnold represented by Fred Andersen (MN); Chlora Lindley-Myers represented by Debbie Doggett (MO); Jon Godfread represented by Matt Fischer (ND); D.J. Bettencourt represented by Jennifer Li (NH); Justin Zimmerman represented by John Sirovetz (NJ); Adrienne A. Harris represented by Bob Kasinow and Jim Everett (NY); Glen Mulready represented by Diane Carter and Ryan Rowe (OK); Carter Lawrence represented by Trey Hancock (TN); Cassie Brown represented by Amy Garcia and Jamie Walker (TX); Jon Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte and Greg Chew (VA); and Nathan Houdek represented by Amy Malm (WI). Also participating was: Elizabeth Kelleher Dwyer (RI).

1. <u>Adopted its July 13, May 15, and Spring National Meeting Minutes</u>

Mears said the first item is to consider adoption of the Task Force's July 13, May 15, and Spring National Meeting minutes. There were a couple of non-substantive editorial items identified that will be corrected. Mears asked for a motion to adopt the minutes from the Task Force's July 13, May 15, and Spring National Meeting.

Crawford made a motion, seconded by Clements, to adopt the Task Force's July 13 (Attachment One), May 15 (Attachment Two), and March 23 (*see NAIC Proceedings – Spring 2023, Valuation of Securities (E) Task Force*) minutes. The motion passed unanimously.

2. <u>Adopted its 2024 Proposed Charges</u>

Mears said the next item is to consider the Task Force's 2024 proposed charges, which are unchanged from 2023.

Doggett made a motion, seconded by Malm, to adopt the Task Force's 2024 proposed charges (Attachment Three). The motion passed unanimously.

3. <u>Received a Report on the Projects of the Statutory Accounting Principles (E) Working Group</u>

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

Jake Stultz (NAIC) said the Working Group adopted several items and briefly discussed several items interest to the Task Torce. First, the Working Group adopted the majority of the items from the Principles-Based Bond Project, including revisions to the *Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds*, *SSAP No. 43R—Loan-Backed and Structured Securities*, and several other SSAPs that were affected by the changes. This effectively changes the Principles-Based Bond Definition for bonds, which includes issuer credit obligations and asset-backed securities (ABS). The changes are effective Jan. 1, 2025. Stultz explained that as part of the same project, the Working Group exposed revisions to *SSAP No. 21R—Other Admitted Assets* to provide guidance for accounting for debt securities that do not qualify as bonds and provide proposed measurement guidance for residuals. The exposure also includes the updated issue paper that details the discussions and development of this guidance. The Working Group would also sponsor a Blanks proposal to revise Schedule BA, and it will send a formal notice to the Task Force and the Capital Adequacy (E) Task Force on the proposal to allow life reporting entities the ability to use existing Schedule BA reporting provisions for Securities Valuation Office (SVO)-assigned designations in determining risk-based capital (RBC) for debt securities that do not qualify as bonds.

Stultz mentioned an item that he explained is less investment-related but has been a major focus within the NAIC over the previous year. The Working Group adopted *Interpretation (INT) 23-01: Net Negative (Disallowed) Interest Maintenance Reserve*, which provides optional limited-time guidance that allows the admittance of net negative disallowed interest maintenance reserve (IMR) up to 10% of adjusted capital and surplus. INT 23-01 will be effective until Dec. 31, 2025, and it will automatically be nullified on Jan 1, 2026, but the effective date can be adjusted. In addition, the Working Group directed the formation of an ad hoc subgroup to work on a long-term solution to the issue.

The Working Group also re-exposed agenda item 2023-11-EP: AP&P Manual Editorial Updates, which provides for revisions to clarify the scope and reporting of investment structures and residual interest, primarily limited partnerships, joint ventures, and other equity fund investments. The agenda item is primarily focused on *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies investments*. There were two additional items adopted by the Working Group: 1) revisions to *SSAP No. 34—Investment Income Due and Accrued*, which clarifies and incorporates a practical expedient to the paid-in-kind interest aggregate disclosure in SSAP No. 34 and *Annual Statement Instructions*; and 2) revisions to SSAP No. 43R to incorporate changes to add collateralized loan obligations (CLOs) to the financial modeling guidance and clarify that CLOs are not captured as legacy securities.

Lastly, Stultz noted that the Working Group will have a shortened comment deadline for four items that were exposed: 1) *INT 23-02: Third Quarter 2023 Corporate Alternative Minimum Tax*; 2) *INT 23-03: Corporate Alternative Minimum Tax Guidance*; 3) agenda item 2022-11: Collateral for Loans; and 4) agenda item 2023-11-EP.

4. Discussed Comments on a Proposed P&P Manual Amendment to Update the Definition of an NAIC Designation

Mears said the next agenda item is to continue the discussion on the comments received on the proposed amendment to update the definition of an NAIC designation. As mentioned during the Task Force's July 13 meeting, the amendment was referred to the Capital Adequacy (E) Task Force, the RBC Investment Risk and Evaluation (E) Working Group, and the Statutory Accounting Principles (E) Working Group requesting comments. Those groups did not have any comments. During the July 13 meeting, the Valuation of Securities (E) Task Force directed the SVO to work with industry on creating a brief, straightforward statement as to the objective of an NAIC designation and why it is different than a rating agency rating and make additional updates to further simplify the definition. The SVO was also asked to consider different ways it could communicate to state insurance regulators the issues encapsulated in the current Subscript S descriptions and examples.

Marc Perlman (NAIC) said NAIC designations are explained and defined in both Parts One and Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). The SVO proposed consolidating the explanations and definitions into Part One, because an NAIC designation is a fundamental policy of the Task Force. The amendment tried to clarify the meaning of an NAIC designation, including a designation's use, purpose, and risks addressed. Given the comments received, additional refinements to the amendment are necessary, such as adding a summary of the overall regulatory objective of an NAIC designation. The SVO met with industry on July 28 to begin discussions on additional definition simplifications and clarifications that can be brought back to the Task Force for consideration at a future date. Perlman said there appears to be some unfortunate general confusion about the proposed definition amendment, as most of the text would be unchanged. Nothing in the update changes the scope of responsibility for the SVO. An NAIC designation should reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, as well as the probability of principal and interest payment default.

There were several references made in the comments to the work conducted by the Risk Subgroup of the Invested Assets (E) Working Group, the predecessor to the RBC Investment Risk and Evaluation (E) Working Group. The Subgroup identified eight different risk attributes of a fixed income investment: credit, deferral, event, liquidity, call, extension, currency, and leverage. The Subgroup noted, "the impact of deferral was already explicitly incorporated into rating agency credit ratings." Given that it is explicitly incorporated into ratings, any deferral of payment is a risk that should therefore be considered as part of credit risk in the definition of an NAIC designation. The other risk attributes mentioned—events, liquidity, call, extension, currency, and leverage—and another risk referenced in the comment letters, portfolio risk, are not part of the current designation definition or contemplated as part of the proposed amended definition.

Perlman explained that a long-standing core objective of the Task Force and its work product, the NAIC designation, which is relied upon for many regulatory functions in the NAIC's Financial Regulation Standards, is to "assess the financial ability of an insurer to pay claims, meaning 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 . . . may result in the insurer not being paid in accordance with the regulatory assumption." This existing regulatory assumption that an insurer should be repaid in a timely, periodic manner is a core characteristic of an NAIC designation and credit risk, and it should be incorporated into the definition. Likewise, the statement that NAIC designations are, "standards identified in the NAIC Policy Statement and Financial Regulation Standards (SFRS) that have been incorporated into state law by States as participants in the Accreditation Programs administered by the Financial Regulation Standards and Accreditation (F) Committee," is a factual statement in the current definition that must remain in the updated definition. Commenters suggested that loss given default (LGD) should also be considered when assigning an NAIC designation. Perlman said the SVO agrees, and including LGD would be a similar consideration to including tail risk in that it is appropriate for certain asset classes, structures, or rating levels. Consideration of LGD and tail risk could be used to adjust an NAIC designation up or down, as appropriate. Perlman said if the Task Force agrees, the SVO can include these considerations in the definition.

Perlman said inclusion of separate instructions related to the assignment of the NAIC Designation Subscript S and its related illustrations also caused unintended confusion. The SVO would be happy to work on creating another means to broadly communicate privately to state insurance regulators that an investment may have unusual risk characteristics. It could take time to implement technology enhancements to deactivate Subscript S and create a new communications channel, such as specialized Jumpstart reports to share with the affected state insurance regulators through NAIC systems. However, Perlman explained that the SVO would be able to continue to communicate any issues or concerns it sees to state insurance regulators through things such as regulator-only educational meetings, informal calls, or new proposals to the Task Force, as needed.

Three comment letters were received: 1) a joint letter from the American Council of Life Insurers (ACLI), the Private Placement Investors Association (PPiA), North American Securities Valuation Association (NASVA), and Structured Finance Association (SFA) that included additional NAIC proceedings from 2008 of the Risk Subgroup of the Invested Asset (E) Working Group; 2) a letter from Athene; and 3) a letter from Anderson Insights LLC. The SVO plans to work on making these updates and bringing a minimally revised version of this amendment back to the Task Force for consideration.

Michael Reis (Northwestern Mutual), representing the ACLI, the PPiA, the NASVA, and the SFA, discussed some of the broad parameters of what may happen with the amendment. He said LGD should be part of the NAIC designation, but there was still confusion about whether tail risk should be in the definition. He said the members of the groups he is representing had varying opinions and need to fully vet it. He asked regarding Subscript S whether there would be a broad statement of what nonpayment risk is within the NAIC designation definition. Charles Therriault (NAIC) said Reis is correct. The concept would remain within the definition, but the separate reporting would be eliminated. Reis said Perlman mentioned a lot. He said the devil is in the details, and he needs to answer to his trade groups' constituents.

Sasha Kamper (Apollo and PPiA) said the PPiA has worked with the ACLI, others in the trade groups, and the SVO on the exposures. She explained that when industry drafted its responses regarding tail risk, the PPiA did not understand how tail risk would be used. In subsequent discussions, she said she understands that the concept of tail risk within a designation definition is to be a principles-based approach. She said she agrees that it is something to look at and figure out the details of how it is used later. She cautioned that if tail risk is included, it is important to be careful that various asset classes are treated fairly and tail risk is applied in a consistent way across asset classes. As she socializes the amendment with her constituents, she will probably have more to say both on tail risk and LGD. She said she is appreciative that it might be appropriate to look at LGD in certain situations.

Mears, with the permission of the Task Force, directed the SVO to: 1) continue to work with industry on the proposed amendment and draft language regarding the consistent treatment among asset classes; 2) include a brief summary of the overall regulatory objective or meaning, which would reflect the likelihood of the timely and full payment of principal and scheduled periodic interest, noting that the risk of payment deferrals will be included; 3) maintain the existing references to the NAIC's financial regulation standards; 4) include consideration of tail risk and LGD when appropriate for the asset class, structure, and rating levels; and 5) within its responsibilities to the Task Force, communicate with the Task Force as it finds different investment characteristics or other areas it believes the Task Force should know and potentially take action on. The SVO may also develop a means to communicate that information privately through internal systems that would not be public documents like Schedule D, and that process may take some time.

Chris Anderson (Anderson Insights LLC) said the topic calls for a very clear, concise definition in simple language that everybody can understand of what is in and what is out of a designation. He stressed that coordination between the other NAIC entities is paramount. As an example, he said if one looks at how RBC C1 and R1 factors were computed, both the frequency of probability of default and the severity were considered. LGD may or may not be in the RBC factors to the extent that it is appropriate. Chris Anderson said it is a matter that should be considered by the other NAIC entities as well, and having a clear and concise definition to share with them could be very beneficial.

5. <u>Discussed Comments on a Proposed P&P Manual Amendment Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the FE Process</u>

Mears said the next agenda item is to discuss the comments received on a proposed amendment authorizing the procedures for SVO discretion over NAIC designations assigned through the filing exemption (FE) process. The topic was introduced during the May 15 meeting, and it stems from the Financial Condition (E) Committee's charge to the Task Force to: "Establish criteria to permit staff discretion over the assignment of NAIC Designations for securities subject to the FE process (the use of credit rating provider [CRP] ratings to determine an NAIC Designation) to ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives." Mears reminded various interested parties of the evolution of the topic. Several years back, the process began of receiving private letter rating rationales to get more transparency into the growing use of private ratings. At that time, there was discussion of the possibility of implementing discretion over those ratings to adjust the designation, should it be warranted, with the expectation that the rating change would be instantaneous and automatic. State insurance regulators at that time decided against that route, acknowledging insurer concerns of feeling whipsawed from waking up one day to a new designation it would need to utilize. Instead, the Task Force provided guidance to the SVO to bring thematic issues back to the Task Force to address, so the Task Force could look at the FE status of those asset classes. Mears said this approach worked well for a while. For example, principal protected securities (PPS) were removed from the FE process. However, the Task Force came across roadblocks as it observed more opaque structures. For example, earlier this year the Task Force deferred action on the proposed amendment related to removing structured equity and funds from FE following criticism from industry that the proposal was too broad. SVO staff recognized some issues with specific securities, and the common feature was the use of what was called structured equity and funds, or a feeder fund. However, there would have been several assets that would have been in scope that were not problematic. It was difficult to provide a scope that would be complete but also efficient in the number of assets that it captured. Industry asked if only the specific problematic securities could be addressed without removing whole swaths of assets from the FE process.

The Task Force was responsive to the industry request and directed SVO staff to draft the current proposal, which is meant to be limited in scope and target specific material risk assessment differences. Mears said the proposal was meant to have a distinct challenge process to provide insurers ample notice, as well as due process, by which an insurer can appeal any potential change well before an FE-produced NAIC designation is affected. The amendment would also address the charge assigned to the Task Force by the Financial Condition (E) Committee. It is incredibly important to note that designations ultimately fall under the purview of state insurance regulators. While the definition is still being worked on, it is necessary to clearly highlight this authority of state insurance regulators and reiterate that designations are solely for use within the insurance regulatory framework, and they are not ratings themselves. The FE process is just that; i.e., exemption from filing that would otherwise be required to be filed with the SVO to receive a designation.

Mears noted that rating agencies, or CRPs, provide an invaluable service, and the NAIC benefits by being able to utilize these ratings in the designation process, when appropriate. Given the number of securities and efficiencies gained by the NAIC in using rating agency ratings to assign NAIC designations, there is no intention of displacing or competing with them. However, because of how the NAIC uses CRP ratings in its processes, this is not an unconditional usage. There is a need and desire to build out a more robust framework for utilizing CRP ratings in the process, and that remains underway. However, Mears explained that even if this is implemented, there could still be instances where a rating is not aligned with NAIC expectations for a designation. The misalignment may even be unrelated to the CRP or methodology. A structure could theoretically have a rating that is fully appropriate outside the insurance regulatory system, but based on whatever policies or procedures the NAIC has in place at that time, the NAIC may need to make an adjustment within its framework.

In exposing this proposal, Mears explained that the Task Force and the SVO recognize that the proposed process is not the final version, and she asked for comments to be as constructive as possible. She thanked the comment letter writers, as many of the letters provided constructive comments. She said there were many good suggestions made by interested parties in the comment letters, and the Task Force and the SVO will be working through many of those suggestions for a modified proposal. Mears commented on some broad themes. First, there is no intent to displace or compete with CRPs. The process was written to be focused on particular assets rather than to subject a broad asset class to removal from FE. The FE status of most assets would be unchallenged. Mears clarified that insurers may continue to use whatever nationally recognized statistical rating organization (NRSRO) opinions they deem appropriate for their decision-making process. The proposal is specific to how NAIC state insurance regulators, as consumers of rating agency ratings for regulatory purposes, choose to use them in the regulatory process. Mears said the SVO will continue to provide a centralized source of investing expertise to support any state insurance regulators in this responsibility. She said while the involvement of an independent, third party to validate individual rating challenges would be costly, inefficient, and not aligned with the NAIC regulatory process, the Task Force should consider how to conduct additional oversight of the SVO in conjunction with the proposal, and that may involve engaging an independent third party to perform a periodic assessment of the reasonability of the SVO's analysis, its operational processes, and supporting systems. She said other themes in the comment letters included additional transparency during the challenge process, more regulatory oversight, and possibly a look-back or review of the process after implementation. She noted that the Task Force and the SVO will look at each of the suggestions and consider carefully how it can enhance the process, whether as suggested or with a minor adjustment.

Therriault said the SVO has reported to the Task Force on several occasions that it has observed growing and often material discrepancies between the ratings provided by competing NRSROs for the same security. The SVO also reviewed with the Task Force specific examples of the significant differences it has observed with some CRP ratings versus the security's issuance spread relative to similarly rated investments, risk assessment differences when applying other CRP methodologies, and comparing the investment to other CRP rated peers. Therriault explained that the examples were all privately issued and privately rated securities, meaning the SVO cannot publicly discuss the specifics of the security, the rating, the rating methodology, or the rating agency. Other than a generic summary of the issue, the SVO is precluded from being transparent about the issues because it must maintain the confidentiality required by non-public investments. Commenters mentioned transparency repeatedly. Much of what the SVO sees are privately issued and privately rated transactions. By their very nature, there is no transparency of these privately issued investments, and the SVO is restricted from sharing all but the most generic information about them. Prior to 2018, when private letter rated securities first needed to be reported to state insurance regulators through the SVO, no one knew anything about these investments or that they were being privately rated. Additional transparency into these securities was only revealed to the Task Force through the SVO beginning in 2022, when the rationale reports first needed to be submitted. The rating exceptions identified by the SVO to the Task Force only came about because of the requirement for increased regulatory transparency into these non-public transactions. Otherwise, the Task Force would continue to be completely blind to these issues. Therriault cautioned that the SVO cannot be put into a position of being required to disclose highly confidential private information to anyone other than an NAIC state insurance regulator who has a regulatory need for this information or if compelled by a court order. Regarding SVO methodology, as the SVO stated on numerous occasions, it frequently uses large NRSRO methodologies, primarily Moody's Investors Service (Moody's) and Standard & Poor's (S&P), when it reviews securities because the SVO general finds those methodologies to be clear, reasonable, and widely accepted across financial markets. Additionally, Moody's methodology served as the basis for the current RBC factors. However, the SVO could provide a highly generic summary without breaching confidentiality, provided it does not identify the security or issuer directly or indirectly, or the rating agency, if privately rated. An example of such a generic summary for a recent filing would be something like the following:

> An insurer submitted a security to the SVO for review in which the insurer applied a Moody's methodology, one of the primary CRP methodologies the SVO often uses to review securities. The insurer's application of the methodology scored the entity's brand strength at the 'AAA' level, while the top brands in this sector that were rated publicly by Moody's only received a 'Baa' for this factor, a substantial seven notches lower. Other financial measures used by the insurer when applying this methodology made adjustments to debt that lowered the amount of debt outstanding, adjustments that improved the financial ratios and are not used in this methodology. The resulting SVO credit assessment differed from the insurer's assessment by three notches.

Therriault said publishing information about the transaction in any greater detail, including the issuer sector and specific methodology, would probably violate the confidentiality the SVO must maintain. The SVO would be willing to discuss privately with those insurers that had invested in the security. If industry finds that level of transparency useful, the SVO could look into publishing that type of information on the SVO web page. As just demonstrated, there can still be significant differences of interpretation when applying a methodology, even from a large rating agency.

Perlman said many of the comment letters point to a rating agency's NRSRO status as a sort of seal of approval by the U.S. Securities and Exchange Commission (SEC), from which the NAIC should derive comfort as to the quality and reliability of an NRSRO's ratings. He said it has been previously explained at Task Force meetings, but which bears repeating, that the purpose of the Credit Rating Agency Reform Act of 2006 (CRARA), pursuant to which the SEC grants NRSRO status, was to foster accountability, transparency, and competition in the credit ratings industry. The CRARA requires NRSROs to make public certain information to help users of ratings, like the NAIC, assess the NRSRO's credibility and compare the NRSRO with other NRSROs. As with other federal approaches to securities regulation, the focus of NRSRO regulation is on disclosure. While the SEC closely monitors the internal controls of NRSROs, governing conflicts of interest and adherence to their own methodologies, under the CRARA, the SEC is prohibited from regulating the substance of credit ratings or the procedures or methodologies by which an NRSRO determines credit ratings. The SEC does not and cannot validate or approve any rating agency methodology. The SEC does not and cannot endorse or certify that there is any equivalency between any NRSRO ratings. Ratings are opinions of risk, and the CRARA leaves it up to the consumers of ratings, like the NAIC, to decide how they will use those rating opinions for their own use, including not using them at all.

Perlman explains that under the current proposal, the NAIC, as a user of ratings, would neither be regulating nor publicly challenging any of the NAIC's methodologies. Additionally, several comment letters proposed oversight processes for the SVO, which appeared to be excessive and intentionally burdensome, given that no such process exists for NRSRO ratings. If a ratings consumer disagrees with an NRSRO rating or the reasonableness of some aspect of its methodology, the consumer cannot appeal to the SEC or an independent third party to overrule or modify the methodology or rating. The consumer can instead use or rely on NRSROs with methodologies that meet its needs. As mentioned in prior meetings and by some of the commenters, there is no provision in any NAIC guidance, such as the P&P Manual, that permits any state insurance regulator or the SVO to overrule or disallow a CRP rating. Perlman said that is precisely the purpose of the amendment, to create a means by which the NAIC can decide, through the efforts and experience of the SVO, how it will use those rating opinions or not use them at all when regulatorily appropriate. The premise that CRP ratings should be untouchable, unquestionable, and unchallenged by the NAIC was implied in many of the comment letters. However, such treatment is in direct contradiction to the policies of the Task Force and the mandate from the Financial Condition (E) Committee. It is also inconsistent with the objective of the CRARA of allowing the consumer of ratings to decide how and if they will use those rating opinions. The NAIC does not avail itself of that right.

Therriault said it would be helpful to step through the proposed process envisioned by the amendment. Step one is the establishment of the materiality threshold required to flag a CRP rating as in a review. To limit the NAIC's use of this process to only that which would be considered truly material differences of opinion, the SVO would only be able to put a security or CRP rating on notice if it determines, based on the available information, that the CRP rating used in the FE process is three or more notches different than the SVO's assessment. The SVO proposed criteria that it has successfully used to identify such exceptions for the Task Force, which is the comparison to peers rated by other CRPs, the securities yield at issuance or current market yield compared to other securities at that NAIC Designation Category level, or the SVO applying methodologies from another CRP. The SVO frequently uses methodologies from very large NRSROs because it finds them to be clear, reasonable, and widely accepted across the financial markets. However, there can still be differences in the application of the methodologies, which can be discussed with a specific insurer.

Therriault said step two is a means to notify insurers that the SVO is looking at the FE-based designation. Nothing changes at that point; it is just a notification. It is anticipated that insurers will provide additional information to the SVO during this notification period to support why the CRP rating should be maintained. What information will be needed depends on the specific types of securities; there is not a standardized list. It is subject to the asset class that is being reviewed and the information available to the SVO. The proposal provides a sufficient notice period to allow an insurer to decide whether it wants to appeal and provide additional information before any action is taken. Insurers would have up to 120 days to appeal the SVO's assessment notification by introducing additional information and data, as necessary. The 120-day appeal period is similar and consistent with the existing appeal period for an SVO-assigned designation. If an insurer appeals, that review process could take an additional 90 days or longer. During the SVO review, applicable state insurance regulators would also have the opportunity to be consulted on the deliberation if they request. If, after the SVO review, it determines that the CRP rating should be excluded for that security, the insurer would have another 120 days to either submit the security for review by the SVO or acquire an alternate CRP rating, thereby permitting continuation of the FE eligibility.

Therriault explained that it may take nearly a year or more from the initial notification until any action is taken on an investment, providing insurers ample time to respond and participate. There will not be any abrupt changes. The discretion process could take two to three years to implement and could be designed to permit multiple insurers that own the security, as reflected in the statutory schedules, to join in the appeal. The connection to the statutory schedules is necessary to allow SVO staff to know which insurers are permitted to have access to the confidential information related to the security and who they can share their observations with given that these may likely be privately rated securities. It would be up to the insurers to decide whether they wish to participate.

Therriault said the SVO assessments of investment risk have been compared to insurers' own investments' assessment of risk, and they have been found to be reasonable. He noted the Society of Actuaries (SOA) study titled, "2003 to 2015 Credit Loss Experience Study: Private Placement bonds," for the topic of "Rating Consistencies: The main quality rating used in the study, the internal rating supplied by the contributors, [i.e. the insurance companies] for each CUSIP for all years, was found to be consistent across two dimensions. Based on comparisons of commonly held CUSIPS, [internal] ratings were very consistent between contributors. They were also reasonably consistent in comparison to NAIC ratings [i.e. designations]."

Therriault then listed actionable recommendations from interested parties that should be incorporated into the proposed amendment:

1. The SVO publishes a generic summary of the reason for its action; i.e., that it maintain the confidentiality of the issuer, rating agency, and rating.
2. Include in the SVO's annual report to the Task Force at the Spring National Meeting information on several ratings challenged, the outcome of the challenges, and the average number of notches of the change.
3. Separately, submit a request to the Executive (EX) Committee authorizing the NAIC to engage an independent third party to perform a periodic review and assessment of the reasonability of the analysis, its operational processes, and supporting systems, and provide the Committee with a private and public assessment and recommendations. It would be up to the Committee as to how frequently such a report should be submitted.

Therriault said credit analysis is both an art and a science; differences of professional opinion are unavoidable. The SVO has proposed materiality thresholds to ensure that it is only focusing on material differences of opinion. The SVO agrees that CRPs have areas of strength and expertise, but they also recognize that there are eight different sources of credit rating opinions today, and those opinions can be significantly divergent. NAIC Designations are specifically intended for state insurance regulators, and they do not have a choice as to the opinions used in their regulatory framework. The proposal gives the state insurance regulators, through the SVO, over which the Task Force has oversight, the ability to align opinions to their risk tolerance. The checks and balances in the proposal, with the modifications that were mentioned, will provide the Task Force and industry comfort that the investment risk assessments are reasonable. The SVO recommends that the Task Force continue its overall assessment of CRP ratings, a project it initiated last year.

Walker said she understood the process, and the direction to SVO staff to draft the process, was about strengthening Task Force reliance upon the CRP ratings, but also allowing a relief valve whenever staff or state insurance regulators notice significant outliers in what is being produced through the process. Therefore, Mears' opening comments, that this process is not intended to replace CRPs aligns with Texas's view. Garcia said it should create certainty for industry going forward that new and emerging asset classes are developed; this process can be used as opposed to creating uncertainty with an insurer not wanting to get into the new asset classes because it does not know whether the new asset class will be FE or not. She said the process is painful at this at this time, but it is a great base and foundation to build on going forward, as there is more innovation in the investment markets, and it will prevent retreading the same ground repeatedly. She said she was excited to hear what Therriault explained about the process. She said it is not perfect now, but we will take all the feedback and work through an iterative process to get something that everybody knows, understands, and is comfortable with.

Cotrone asked Therriault to confirm that no action will be taken on an NAIC Designation until after the insurer is notified and can go through the full appeal process. Therriault confirmed and explained that first there would be notification that the SVO is looking at something that it thinks is off the mark. The insurer could provide information to discuss that with the SVO. At that point, the SVO will know, if it is a private rating, that it has the ability to breach that confidentiality shield. Then, the SVO can discuss that with the insurer and decide if it wants to appeal. When the SVO decides that it should be removed from FE, there is still the option to go to an alternate rating agency to get a different answer or file the security with the SVO for review. Therriault said the process could take nearly a year before security moves from FE to out of FE or to another CRP.

Mears said several comment letters were received on the proposal, and she wants to ensure that everyone has a chance to speak to their comments. She listed the comment letters: a joint letter from the ACLI, the PPiA, the NASVA, the SFA, the Mortgage Bankers Association (MBA), and the Commercial Real Estate Financial Council (CREFC); the Lease-Backed Securities Working Group; Chris Anderson; Michelle Delaney; the National Association of Mutual Insurance Companies (NAMIC); the Bank of Montreal (BMO); Genworth; Teachers Insurance and Annuity Association of America (TIAA) Financial Services; Piper Sandler Companies; Group 1001; and Marty Carus (Martin Carus Consulting LLC).

Reis said he would briefly summarize the letter from the ACLI and the joint trades with the most basic concern being related to transparency. The first issue is that the designation challenge rests with the SVO and one state insurance regulator, yet other insurers may hold that same security, perhaps in other states, potentially resulting in extraterritorial regulatory approval. Also, the SVO would be making its objection or determination of a material discrepancy based on incomplete information. Then, on appeal, the insurer would be allowed to provide additional information. Reis said that seems more like an initial filing rather than an appeal. He said this was concerning to many members of his constituency. He said his constituency also thought there should be additional checks and balances on “appeals.” He said there should maybe be a third party so the SVO is not judge, jury, and executioner, a term discussed by his constituents. He explained that there should be transparency to all partners affected and transparency about what is affected, whether it is just the security; a whole asset class; a subset of an asset class; something broader than the asset class, such as a methodology; or one or more rating agencies. There should be transparency as to the rationale and what was inappropriate with the rating rationale. Reis explained that the reason for the transparency request is if there is a problem with a security and that rating gets changed, industry will be left wondering whether the problem is with the whole asset class or a subset of that asset class. Industry is concerned that the private market, of which industry holds substantial assets, could freeze. Reis said there have been instances where certain segments of that market have been frozen due to challenged ratings or similar things. He said industry is ready to assist in addressing specific problems that are identified, but there are problems with transparency. He said Therriault had mentioned that the SVO uses large rating agency methodologies, but industry has heard that those rating methodologies can be misapplied. He explained that a rating methodology applies to apple pie, but it might inappropriately be applied to pumpkin pie. He said there are specific instances where that has happened, and he said he could share the details later. He then addressed materiality. He said it is predicated on a material discrepancy in ratings, and the SVO would be making its objection to a rating with incomplete information. He then addressed the appeal, which he said is not really an appeal but rather a security filing so the SVO has complete information. He reiterated his belief that there is not a real appeals process where there is recourse other than to the SVO.

Mears asked Reis to describe his concern about the providing of incomplete information. She asked if it is that he would want to see that happen in a different order. She explained that by its nature, the SVO would not receive complete information. She asked Reis what he believes the process should be.

Reis said he would answer in two ways. One, the process as outlined would be that the SVO thinks the rating is X, which is three notches higher or lower than the rating that is assigned; therefore, your insurer can file an appeal. Otherwise, the SVO rating stands. Reis explained that the SVO assessment was made with incomplete information, which seems like a backwards approach and is not really an appeal. He said if there were a process, and he clarified that his group has not talked about what the solution is, and the SVO would like to get additional information, it could be shared. He said that is a different process; i.e., the SVO saying it has the answer based on incomplete information.

Therriault said the process envisioned was for the SVO to give notice of what it is thinking and, at that point, to ask industry, through the notification, for additional information. If industry believes the SVO is off the mark, that would be the means by which the SVO would get the information Reis described. Therriault explained that if the SVO does not have a means to communicate to all parties that may be invested in the security in an efficient way, the SVO will not know who to reach out to, how it is going to get the information, and how it is going to be transmitted through NAIC systems. He explained that even if the SVO received the information, it would not be an automatic change in the designation. The only thing it would do is remove it from the population of FE, which then means it is a status change, then the insurer has other options to avail itself, such as another CRP rating if they want to request an alternate review, or a traditional full SVO filing, if the SVO had not received sufficient information already.

Reis said much of the process outlined by Therriault presumes that the rating is wrong based on the SVO assessment, which is based on incomplete information.

Therriault said that is correct, but he referred to the comments made by Perlman; i.e., there is no challenge process for a rating that exists anywhere. One cannot tell the SEC that rating agency X's rating is incorrect and ask the SEC to overrule it or make the rating agency change the answer. Therriault explained that this is a way for the state insurance regulators to avail themselves of a professional group that supports them to provide that function.

Mears said maybe there is another notification process where additional information is needed or something along those lines. She said we can take back that concern and think through what the enhancements would be.

Reis said there is a strong conceptual concern, but there are broad implications. If there is a hundred X types of securities in the market, one of those securities gets picked, and that rating gets notched down three notches, it is going to spread like wildfire through industry that the SVO has a problem with X security. Reis explained that industry would not know what the problem with the security is, and questions would arise, such as whether the whole population of 100 securities is at risk; whether it is a sub-population of those 100 securities that has certain characteristics; or whether it is the rating agency methodology that may rate 40 of those, but the other 60 are not at risk. He explained that if there is fear in the market, that whole population of securities could freeze up because certainty of capital is lacking.

Kamper talked regarding incomplete information. She said what industry envisioned that the information that the SVO would have on the security is the private ratings letter and whatever information is available on Schedule D. The SVO would not have had access to the financials, a private placement memorandum, the legal docs, etc. When this proposal is put into action and those securities would be flagged, that is then when the SVO would come and talk to the insurer; the insurer would provide that information; the SVO would do a more thorough due diligence; and there would be a discussion most likely between the insurers that own the security, the CRP that rated the security, and the SVO. Kamper said her constituents view that dialog as similar to an initial filing, as if the SVO would have designated and assigned a designation absent a

CRP rating. She said one of the concerns is that in the rare chance that after going through that process, the insurer and the SVO cannot come to a meeting of the minds and the insurer still feels strongly that there are fundamental reasons why the rating is appropriate and there is information the insurer wants to present, there needs to be a second place to have that dialog again. She said it is important that in the rare situations—most likely a methodology challenge—where there is something fundamental about the asset class that would affect a broad number of securities, not just any individual security, insurers would like to be able to bring its concern to the Task Force, or some subset thereof with expertise in these issues to bring the concern to. She said she would not envision that happening frequently, but she believes it is important to have an additional place of appeal because her constituents view the 120 days in the exposure as more like an initial filing. With respect to confidentiality language, she said she understands it is a big challenge, but she knows the SVO has provided some examples in the past where it has masked which rating agency assigned the rating and just speak in terms of NAIC equivalent ratings, and it has masked the name of the issuer and watered down the information enough that people can understand what the nature of the underlying transaction is, but it does not necessarily give away who the rating agency is or who the issuer on the deal was. She said the SVO has been able to overcome that challenge in the past and share with the small group, and that is the type of disclosure that industry is looking for here, mainly to avoid what Reis was referring to, meaning the situation where if many insurers have similar securities and the SVO is concerned about a very specific issue that affects the security or a certain methodology, that it does not cause unnecessary disruption to a broader range of securities than just that the SVO is concerned about and wants to challenge and talk about. She said from her constituents' perspective, transparency is key and would appreciate to the extent that the SVO can accommodate, as well as adequate due process, meaning a place to have concerns heard, be able to have a good dialog, and hopefully get to a decision that makes sense for everyone.

John Garrison (Lease-Backed Securities Working Group) said the Lease-Backed Securities Working Group believes the investment community and the state insurance regulators share the same desire for efficient, well-regulated markets that benefit everyone. It goes without saying that markets hate uncertainty. Any policy that allows the NAIC to question and potentially overturn individual CRP ratings after a bond has been purchased by the investor will inevitably create uncertainty in the markets and have a harmful effect on insurance companies, and they will be the only market participants subject to this added uncertainty. Garrison said even the mere discussion of the issue has already started to freeze markets for many securities where insurance investors have simply said they are not going to consider it because there is too much uncertainty involved with making that step. That being the case, the Task Force should strive, wherever possible, to minimize the negative impacts of the policy while preserving the ability to effectively regulate. This could be done, Garrison suggests, by limiting the scrutiny to only those companies where state insurance regulators feel the problem rises to a level where it could have a material impact on an individual company's capital ratios, or by making it clear that only certain classes of securities would be subject to this additional level of scrutiny. Responding to the comments of Reis and Kamper regarding incomplete information, Garrison said the fear is that the SVO will always be operating to some extent on incomplete information. To the extent that NRSROs can talk to management, they can do many things that the SVO is unable to do and that the Lease-Backed Securities Working Group believes the NRSROs will always have a bigger, fuller picture of a credit. Garrison said any analysis by the Investment Analysis Office (IAO) that questions the work of an approved CRP should be justified to the investor in the form of a full ratings rationale report equivalent to the fulsome reports published by the NRSROs and already provided to the SVO, which provide a detailed explanation of the analysis by the CRP, the credit issues, the legal issues, and any mitigants. Regarding the phrase of blind reliance on ratings, he said he understands that the state insurance regulators want to preserve the ability to question ratings in some instances, but it is hardly blind. The report prepared by the SVO or the IAO should highlight specific errors and omissions in the CRP analysis and the specific reasons the IAO reached a different conclusion. Garrison said the sample paragraph Therriault read as an example is insufficient. He said the SVO cannot just say it looked at all the same information, but it just came out with a different opinion. He also agreed that many of the proposed steps put forward by the Financial Condition (E) Committee framework to modernize the SVO, including the establishment of a broad investment working group under the Committee to act as an adviser and hopefully to harmonize the various different investment-related projects that are underway, including this one, and also with the hiring of an external consultant to advise the Working Group and provide guidance on any policy-related issues. He said the Lease-Backed Securities Working Group believes that these recommendations, as well as the other steps contained in the Committee framework, should be brought into this discussion before any specific policies are implemented by the Task Force.

Chris Anderson said his comments are in the context of the Bond Project, which had just been adopted and should give state insurance regulators confidence that some of the problems that existed or may have existed will be dealt with. Turning to his letter, he said his conclusion was that it would be terrific to have a fresh look at how state insurance regulators can benefit from the resources of the NAIC with respect to their responsibilities to assess the credit quality of the assets of insurers. He referenced a study 25 years ago from an outside consultant and another more recent one saying those kinds of recommendations are appropriate now because the discretion proposal is a sweeping change in the responsibility of the SVO. He said years ago, the SVO was responsible for coming up with securities valuations, and now it comes up with some measure of risk, which in his opinion is essentially credit risk. He said it may well be time to look more fundamentally at how you can be served the best, and hopefully that can be addressed.

Chris Anderson said with respect to this proposal, there is tremendous new power that the SVO will have, and the idea that a security or a class of securities can be put under a cloud for even a brief period of time is market making and market moving and should not be ignored. The notion that it can be done for a year is inconceivable to market participants who are looking at securities on a moment-to-moment basis. The idea that one insurer may have information that other insurers may lack about the status of security and the reasons it is under a cloud can influence the fairness of trading. It could even prohibit the insurer from selling a security because of fear of trading on material nonpublic information. Chris Anderson said a proposal this sweeping needs to be accompanied by better governance, which is the theme of his letter. Regarding better governance, he said he outlined specific steps state insurance regulators can take to oversee the processes. The most fundamental step is something that existed before namely one, but probably more than one, working groups specifically dedicated to these questions. He clarified that a working group is a group that would actually do work. He said there cannot be 26 task force members all responsible for what goes on at the SVO; although, ultimately, they are. However, the Task Force needs arms and legs; i.e., people who are focused on it. Chris Anderson said in his letter that he outlined specific steps that can be taken for the Task Force to have visibility as to what goes on in the process.

The model is essentially what the SEC did when it wanted to have visibility and transparency to the work of rating agencies. Chris Anderson said it has been called burdensome, and he said it would take a significant period of time. He said he understands that that it would be a burden for the SVO because it has never done many of these things. He explained that the SVO has never produced the kinds of documents outlined in his letter, not the least of which is a ratings transition matrix, in other words the SVO's report card. With those documents, the Task Force will be able to assess the work that is being done by the IAO. Chris Anderson asserted that the idea that, as in the proposal, once a year the Task Force may request information about what the IAO has done in this regard is indicative of the notion that the proposal contemplates no disclosure. He said he is advocating for a group that digs into the operations of the SVO and demands accountability.

Chris Anderson said a second group that would be useful is something that existed many years ago, called the Rating Agency Working Group. The Working Group worked closely with the SEC. Chris Anderson said a web search will show interaction between the SEC and the NAIC concerning what kinds of information the NAIC would want. There are many things the Task Force could do, as state insurance regulators, if it had a working group to review the capabilities and performance of the NRSROs. Chris Anderson said Form NRSRO has incredible detail about the performance of rating agencies, and it is a model for the IAO. The SEC reports annually on infractions or performance of rating agencies in a generic form, but there are several things the Task Force can do if it wants to focus on and improve state insurance regulator visibility on the performance of the NRSROs.

Chris Anderson is afraid that aside from the clouds it will cast over various securities and classes of securities, there are problems with this proposal. He asserted that the notion that one can come up with a three notch difference by using peer review, yield analysis, market yield, and other tools is flawed. He said by peer review specifically, the example of 43 securities was an apples-to-oranges comparison, and that was referred to an ad hoc group. He said he understands that that approach was never validated. Furthermore, if this is not intended to be used to an apples-to-apples review, in other words, two rating agencies rating the same asset, then for private placements, the SVO has noted that only 15% of private placements are rated by more than one rating agency. That means 85% of the private placements the SVO would be looking at would not be able to do an apples-to-apples review. Chris Anderson summarized that the proposal needs a lot of work, and hopefully there will be an opportunity for outside consultants to look at it.

Mears summarized Delany's comments stating that Delany noted that the NRSROs are regulated by the SEC and described the application process. Delany goes on to note that the NRSROs focus on collateral, along with the credit worthiness of the borrower. She highlights that she relies upon NRSROs for making credit decisions in a former role at a large regional bank. She suggests that the SVO should also be subject to an independent review in its provision of designations, as well as highlighting the suggestion that a third-party provider could assist with the request for proposal (RFP) for the review of the NRSROs.

Colleen Scheele (NAMIC) said NAMIC agrees with all other interested parties as it relates to transparency, and it looks forward to continuing the conversation with state insurance regulators and NAIC staff.

Mears summarized BMO's comments stating that BMO provided some considerations based on its observations. BMO noted that the rating agencies have been approved as NRSROs by the SEC due to comfort with their rating methodology and track record over time. They would like rating certainty, as there could be impacts to deal flow. They also note that adoption of this proposal could set a precedent for future negative amendments, increasing the riskiness of investing in private placements.

Michael Shepherd (Genworth) said he believes Genworth's concerns had been addressed by the ACLI and others.

Mears summarized the TIAA's comments stating that the TIAA has specific concerns with Sections 81 and 170 of the proposal. The TIAA does not believe the proposal demonstrates a requirement for the SVO to provide its own analysis or explanation as to why the CRP provided rating was challenged. The TIAA also makes a reference to an assumption that we have gone through this process before with 43 securities, and the Task Force did not approve a method to override the ratings at that time. The TIAA recommends that a clear methodology be outlined, and it noted that the SEC closely regulates all the NRSROs.

Mears summarized Piper Sandler's comments stating that Sandler indicated that the current NAIC proposals have already caused major market disruption as word of the pending proposals permeated all levels of the insurance industry. They said some number of insurance companies have instituted a moratorium on certain rated transactions in the markets, and prior to buying a particular transaction, insurance companies should know what the NAIC Designation will be in order to monitor the regulatory capital charges. They talk about some of the rating agencies that are in the market, and they have seen some potential drop off in the total number of deals and respective transaction sizes. An increasing number of insurance company investors learned of the proposed NAIC/SVO's intent to provide the credit risk designations to FE securities, and they noted that the market has come to a virtual halt denying many strong and viable companies the ability to raise capital. They give some statistics regarding some of the ratings that have been in place. They note that the NAIC/SVO does not have the required resources, analytical capability, or regulatory status; i.e., not an SEC-regulated NRSRO to implement unexpectedly high credit risk designations. They say insurance clients always carry out intense due diligence and all corporate credits that have come to the market. They note that this could impede the ability of smaller corporations to raise capital and provide strong value added investments for the insurance industry.

Bob Turner (Group 1001) said Group 1001's letter echoed many of the other themes from the other letters. He said he wants to discuss the impact of the Bond Project. He said many of the examples brought forth to industry in previous meetings would be addressed by the Bond Project and the new definition. Consideration should be given not just in the scope of securities that could be affected, but the timing of having to implement the Bond Project at the same time. The total scope of this proposal seems to be unlimited and could affect any number of securities, so there should be some consideration given to certain attributes of securities. Previously, there was the bespoke security letter that talked about red flags. Likewise, there should be attributes to some securities where insurers can have confidence that there will not be any expectation of a challenge based on certain attributes of those assets within the marketplace. Turner also said he echoed what other people said about transparency, and more insight into specific concerns would allow industry to come to the table with some alternative solutions, as well as the SVO's methodologies so people can better understand any appeal process and what the SVO's rating methodology would look like.

Mears summarized Carus's comments stating that he notes his experience as a state insurance regulator for 43 years and participation in NAIC activities during that tenure. He is now a consultant, but he offers his comments as a consumer policyholder of various insurance products and investor in insurance companies and as a taxpayer. He notes this proposal, like most NAIC proposals, does not define the associated costs that are ultimately borne by policyholders or investors. The proposal also does not estimate quantification of the benefits associated with it. As a taxpayer, Carus finds this problematic. He views this proposal as an attempt to overturn the existing FE process. He notes that no major market participant has encountered a severe adverse market event in decades. He lists several questions, including why the proposal is being made at this time, why there is no materiality threshold, what specific conditions have arisen, whether the insurance industry has experienced a financial strength decline due to its investment operations outside of the normal cyclical economic conditions, whether there are examples of companies abusing the fee process to the extent that its RBC calculations were materially misstated, and whether the current solvency regulatory regime is good enough as it is. He then goes on to note concerns with the fact that the timing of the challenge would occur after the investment is made.

Steve Broadie (American Property Casualty Insurance Association—APCIA) said the APCIA did not file comments, but it wants to associate itself with comments made by the ACLI and the other trade associate associations that joined in that letter.

Mears said the next steps are for the Task Force to provide direction back to SVO staff. The direction is to work through the actionable comments in the comment letters and incorporate, as needed. Mears said she would look to Task Force members if there are any specific areas that should be highlighted and further discussed.

Crawford said from the Nebraska standpoint, as heard from several commenters, there is a need to look back at the appeal process and the process of bringing the concerns to an insurer. The ultimate authority needs to rest with the states, and there should be a solution where the authority lies with the states. It could be through a committee, because of the issue of when a company in one state of domicile affects multiple. Crawford mentioned overall transparency and heard the concerns that were brought before the Task Force. The Task Force needs to take those seriously and provide as much transparency as it can, understanding the legal implications of that.

Cotrone said Connecticut agreed with Nebraska's comments. He said there is a need to take into consideration interested parties' comments, such as how to improve the process. He said the comments have provided some very valuable insight.

Mears said most Task Force members would be in agreement that increasing transparency would be a priority. It can be looked into in accordance with the confidentiality issues. There should be an annual report on the number of ratings challenges, outcome of challenges, average number of notches, and possibly some interim reporting, particularly at the initial onset of such a process. Mears said the Task Force should request the engagement of an independent third party to periodically review the operations, analysis, and systems of the IAO. It would require Executive (EX) Committee authorization, but there is the Financial Condition (E) Committee framework that contemplates the usage of such a resource for a purpose like this. Every suggestion that was made will be reviewed in good faith to determine whether it can be incorporated into the process. Mears asked Task Force members to read through the comments and think about this so further guidance can be provided to the SVO as this proposal is updated. She noted the related pending Financial Condition (E) Committee exposure stating that it is much broader than this Task Force proposal. As comments are received on the Committee proposal that may have implications for the Task Force initiative, that will need to be considered.

6. Heard a Staff Report on the Proposed CLO Modeling Methodology and the Ad Hoc Working Group

Eric Kolchinsky (NAIC) said the collateralized loan obligation (CLO) ad hoc group has continued to set the assumptions for CLO modeling. The assumptions for prepay and purchase pricing were recently finalized. The next step is to look at scenarios and probabilities. There will be a suggested set of scenarios, and based on those, the CLO ad hoc group will seek to set probabilities such that the risk of the underlying loan is approximately equal to the risk of the sum of the tranches. Kolchinsky said the next meeting of the CLO ad hoc group would be after Labor Day.

7. Received Final CRP Questions

Mears said the next agenda item is to note that the SVO received feedback on the initial list of questions to CRPs. She said the responses were private because some of them came from the CRPs themselves, and the Task Force was not going to publish those comments. The responses helped to create a final list of questions, which are published on the Task Force website. The submissions will be formalized to the CRPs, which starts the timeline of scheduling meetings with them as the responses are received over the coming months.

8. Discussed Other Matters

Mears had one additional matter. Fitch Ratings downgraded the U.S. government to AA+ from AAA. Along with S&P, that makes two rating agencies that no longer maintain an AAA rating on the U.S. Currently, the NAIC Designation of U.S. government obligations is fixed in the P&P Manual at NAIC 1.A. Therefore, any upgrades or downgrades do not change the NAIC Designation as they would with the FE process. If the NAIC Designations were governed by the FE process, U.S. government obligations would be at NAIC 1.B. Mears said the Task Force will need to talk about this issue. She said there is no recommendation, but she wants to ensure that the Task Force understands the implications and how that flows through the system, and if there is anything the Task Force needs to address, either within the Task Force or even with some of the groups the Task Force coordinates with, including the Statutory Accounting Principles (E) Working Group and the RBC Investment Risk and Evaluation (E) Working Group.

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

https://naiconline.sharepoint.com/teams/svovostaskforce/shared documents/meetings/2023/2023-08 summer nm/minutes/vostf_2023-08-14_summer_nm_minutes v5 (final).docx

Draft: 8/1/23

Valuation of Securities (E) Task Force
Virtual Meeting
July 13, 2023

The Valuation of Securities (E) Task Force met July 13, 2023. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Eric Dunning, Vice Chair, represented by Lindsay Crawford (NE); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone (CT); Michael Yaworsky represented by Ray Spudeck (FL); Dana Popish Severinghaus represented by Vincent Tsang (IL); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Bill Warner (LA); Kathleen A. Birrane represented by Matt Kozak (MD); Gary D. Anderson represented by Jim McCarthy (MA); Grace Arnold represented by Fred Andersen (MN); Chlora Lindley-Myers represented by Debbie Doggett (MO); Justin Zimmerman represented by John Sirovetz (NJ); Adrienne A. Harris represented by Jim Everett (NY); Carter Lawrence represented by Trey Hancock (TN); Cassie Brown represented by Amy Garcia (TX); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays (WA); and Nathan Houdek represented by Amy Malm (WI).

1. Adopted a P&P Manual Amendment to Clarify the Meaning of Repurchase Agreements in the Derivatives Transaction Definition for Funds in Part Three

Mears said the first item on the agenda is to discuss and consider adoption of a proposed technical *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) amendment to clarify the meaning of repurchase agreements, or repos, in the derivatives transaction definition for funds in Part Three of the P&P Manual.

Marc Perlman (NAIC) said in 2021, the Task Force adopted amendments to the NAIC Fund Lists section of the P&P Manual to provide greater clarity and predictability regarding the applicable use of derivatives in funds and permit funds greater flexibility in their use of derivatives while maintaining limits on funds' use of leverage. The Securities Valuation Office (SVO) proposed a new amendment to clarify which side of a repurchase agreement constitutes a derivative transaction for the purposes of the definition. The original amendment was intended to limit the use of leverage by funds; therefore, the derivative transactions definition encompasses instruments pursuant to which a fund may be required to make a future payment of cash or other assets. Likewise, the inclusion of reverse repurchase agreements, as based on the U.S. Securities and Exchange Commissioner (SEC) definition in Rule 18f-4, was intended to capture arrangements by which the fund would allow a future cash payment to the counterparty. However, to maintain consistency between the P&P Manual and the Statement of Statutory Accounting Principles (SSAPs) and eliminate any misconception that a fund cannot be the purchaser of securities/lender of cash, the SVO proposes changing reverse repurchase agreement to repurchase agreement in the derivatives transaction definition. To be clear, the SVO is not intending to change the meaning. Rather, the same side of the transaction was named differently by the SEC and the SSAPs, and the SVO wants to be consistent with the SSAPs. The proposed amendment was exposed for a 45-day public comment period that ended June 30, and the Task Force did not receive any comments.

Everett said the SEC definition is written from the broker-dealer perspective. He asked if it makes a difference that the Task Force is now dealing with the issue from a broker-dealer perspective rather than a counterparty perspective.

Perlman said regardless of the perspective, the SEC defined it in reverse. The SEC was looking at it from the fund perspective. It just defined it in reverse. Not only was it the opposite of what is in the SSAPs, but it was also the opposite of the general market convention. The SVO wants to align it with the SSAPS.

Michael Reis (Northwestern Mutual), representing the American Council of Life Insurers (ACLI), said the ACLI supports adoption.

Spudeck made a motion, seconded by Andersen, to adopt the P&P Manual amendment to clarify the meaning of repurchase agreements in the derivatives transaction definition for funds in Part Three (Attachment A). The motion passed unanimously.

2. Receive Comments on a P&P Manual Amendment to Update the Definition of an NAIC Designation

Mears said agenda item number two is to receive comments on a proposed P&P Manual amendment to update the definition of an NAIC designation. Once comments are received, direction will then be given to the SVO from the Task Force. Mears noted that because referrals were mentioned in the letters, the amendment was referred to the Capital Adequacy (E) Task Force, the Risk-Based Capital (RBC) Investment Risk and Evaluation (E) Working Group, and the Statutory Accounting Principles (E) Working Group. The Valuation of Securities (E) Task Force requested that these groups let the Task Force know if the definition meets their needs. If the definition meets their needs, no response needs to be submitted; if the definition does not meet their needs, these groups should notify SVO staff. The Task Force gave a date of June 29 for each group to notify that it may be proposing a modification to the definition of an NAIC designation or request additional time. The Capital Adequacy (E) Task Force distributed the referral to its members and requested comments or recommendations on the definition of an NAIC designation by June 19, and no comments were received. The RBC Investment Risk and Evaluation (E) Working Group and the Statutory Accounting Principles (E) Working Group also distributed the referral to their members and requested comments and recommendations on the definition by July 7, and no comments were received. As no comments have been received nor indications that comments are forthcoming, the Task Force can presume that there will be no further comments, but it certainly will listen to any issues or anything that may arise from these groups if they still were to arise. Mears noted that a joint comment letter was received from the ACLI, the Private Placement Investors Association (PPiA), the North American Securities Valuation Association (NASVA), and the Structured Finance Association (SFA), as well as letters from Athene and Anderson Insights.

Therriault said, as mentioned in the last Task Force meeting, NAIC designations are explained and defined in both Parts One and Two of the P&P Manual. In this amendment, the SVO proposed consolidating the explanation and definitions to make a single uniform definition in Part One that captures all policies and concerns of the Task Force in one place. The amendment added clarifications as to the meaning of an NAIC designation, including their use, purpose, and the risks they address, as these attributes should also be policies of the Task Force, and it explains why NAIC designations are different from credit rating provider (CRP) ratings. The consolidation included the incorporation of the “NAIC Designation Subscript S” illustrations in Part Two into the “NAIC Designation Subscript S” subsection, of “NAIC Designations” in Part One because the description of other nonpayment risk is also a policy of the Task Force. Most of the updates in the amendment involve existing language that was either moved, consolidated, or eliminated if there was redundancy. The new text primarily clarifies the regulatory meaning and objectives of an NAIC designation and expands on the existing guidance. These changes were highlighted in yellow.

Reis, representing the ACLI, the PPiA, NASVA, and the SFA, said there are two related issues, which he will take separately: 1) the changes to an NAIC designation; and 2) Subscript S. He acknowledges that these are somewhat the same and interrelated, but he believes it is easier to address them separately. The three proposed changes to the NAIC designation are: 1) an NAIC designation should reflect the probability of default; 2) it should reflect tail risk; and 3) to a lesser extent, it should be in the context of the NAIC Policy Statement on Financial Regulation Standards (SFRS) and other NAIC guidance. Part of the challenge for constituents is there was no reason given for the changes. Therefore, the impact, if any, is not understood. For example, if a rating agency used loss given default (LGD) in its methodology, there is the question of whether that means it does not comply with the probability of default and is therefore void. Reis noted that the RBC factors were determined using LGD. If nothing changed, then there is nothing to object to. However, if something changed, that should be understood.

The Capital Adequacy (E) Task Force did not comment about whether the proposed definition changes met their needs. The Task Force was asked to weigh in if anything in the proposed definition changes what an NAIC designation represents (e.g., the LGD versus probability of default or the tail risk), how that would be assessed, whether it would be similar, and whether that would be assessed similarly for a credit issuance bond or the same for asset-backed securities (ABS). If the proposed definition changes anything, another referral can be requested of the Capital Adequacy (E) Task Force or some acknowledgment that nothing changed and why.

Related to Subscript S nonpayment risk, included was a letter that was previously submitted. It is unclear if those questions were answered. This is a big change from what the P&P Manual says, and it is a big change in practice, or at least it could potentially be. It is also a big change from a comprehensive study with conclusions reached by the Valuation of Securities (E) Task Force back in 2008.

The comments distinguish between individual credit risk and portfolio risk. For example, interest deferral may be of interest to state insurance regulators if there are a lot of interest deferral securities. If it is being reflected in asset adequacy testing (AAT), that would be very different from a security with nonpayment risk (e.g., perpetual bonds), where it could miss payments and there are no repercussions. There is an agreement that would be nonpayment risk, and it should possibly be notched, but it is unclear if there is appropriate distinguishment, especially if this proposal means that all interest deferral bonds, all 40-year bonds, and all things that are listed as Subscript S would have to be filed with the SVO. The intent is not really understood, and the ask is twofold: 1) work collaboratively with the Task Force and the SVO on this; and 2) make sure everything is transparent and understood. This begs the question of whether that means 40-year bonds are filed or if that is portfolio risk versus individual credit risk. That is the summary of the letters, and the groups want to be constructive and work with the Task Force and the SVO to address the concerns.

John Golden (Athene) said Athene is right where the joint trades are in terms of the overarching concerns regarding Subscript S. The only thing to add on top of that are the concerns at the higher level above that, which is how to ensure a consistent framework across asset classes that are properly interpreted in the principle of equal capital for equal risk. Looking at a feature like Subscript S, it effectively has a notching right, that presumes that there is a consistent framework where rating agencies have a clear role, as defined, and state insurance regulators, the SVO, and everybody knows how they operate. For that reason, it is premature to have the proposal with a notching right when the basics of who does what under what methodology and how that interrelates with capital charges but also the broader RBC framework. It is hard to really understand how a notching right can be presented at a point where some of these basic foundational issues remain. A larger workstream is proposed that will oversee all the changes that are going on that are parallel across multiple different groups and ideas and functions to bring all of these workstreams together into an overarching look at the framework in its entirety. The rating agencies have a very significant role to play in this framework and the capabilities to perform the primary credit risk assessment across all asset classes effectively that are able to be rated at all. As a structural matter, the state insurance regulators and the SVO, in concert, should have better tools and more governance to oversee rating agencies, interact with them, and make sure they are meeting the credit risk and regulatory assumptions and principles that are set out by the NAIC. When there are bifurcations in how credit risk is determined, by whom or under what methods, or what tools apply to some asset classes or others, those are large concerns.

Mears said Athene's comments focused on the Subscript S component of the proposal, and she asked if Athene had any comments related to the NAIC designation definition itself. Golden said when thinking about how capital is ultimately set in the insurance industry, there are three things needed: 1) who is doing the assessment, because who is doing it matters; 2) under what method: a) intrinsic price; b) Moody's Investors Service (Moody's) methodology; c) Standard & Poor's (S&P) methodology; or d) something else; and 3) how that ultimately relates to the capital charges that were set up. All three of those things are now being proposed to effectively float relative to each other in some way. That is a very big problem in the long run. It is not a regime where there is a clear demarcation of lines and separation of duties and oversight. Sometimes there are people doing certain things depending on what asset class that is. When you think about what an NAIC designation is, it starts with basically what is a rating and then where the NAIC designation needs to be different than a rating. The question that should be asked in a very broad way is what it is that is trying to be solved with that rating versus an NAIC designation. If there is something about the rating agencies that they are doing that does not meet the regulatory objectives of an NAIC designation, a conversation should be had about that.

Chris Anderson (Anderson Insights) said the first thing to note is that there should be a clear definition of what is meant by an NAIC designation. Thinking about the charges of the Task Force, it has the ability to consider all kinds of metrics for assets under charge 4. Under charge 7, of which it is charged with coordinating with other working groups, such as the Capital Adequacy (E) Task Force, the Statutory Accounting Principles (E) Working Group, etc., it is also charged with ensuring that the objectives of its guidance is incorporated into the P&P Manual. It seems that the P&P Manual is looked at first before coordinating on a simple definition of what is meant by an NAIC designation. The principal user of NAIC designations is the Capital Adequacy (E) Task Force because it is used for the R1 and C1 factors. Therefore, when the Valuation of Securities (E) Task Force had that discussion with the Capital Adequacy (E) Task Force, the question was what does the Valuation of Securities (E) Task Force expect the Capital Adequacy (E) Task Force will say it wants in a simple definition. Because the rating agency ratings were used as a basis for R1 and C1 factors, even as it was recently revised, the Capital Adequacy (E) Task Force used essentially ratings of corporates, so the question is whether that is all the Task Force might want to have and is it adequate for the Task Force. That is the Task Force’s call. The Task Force should be deciding what the basis for NAIC designations should be in the definition for NAIC designations. It has been said several times that NAIC designations are part of RBC, but RBC is a blunt instrument, so it is not necessarily precise. Additionally, because the Capital Adequacy (E) Task Force is such an important constituent, the definition should probably be tailored to its needs rather than the needs of someone who is developing this.

When thinking about credit, credit is risk of nonpayment. It is whether the investor is going to get paid. An analyst starts with the term sheet and moves on to the prospectus looking at all the terms and conditions in the transaction, not just maturity but every element. Those are all considered. They are considered by the analyst, the analyst supervisor, and the credit committee, and they all decide what the risk of nonpayment is from 1 to 10. The NAIC has had some differences and has acted through the Statutory Accounting Principles (E) Working Group to redefine bonds. Therefore, there are things rating agencies may have rated, and now thanks to the efforts of the Capital Adequacy (E) Task Force and the Statutory Accounting Principles (E) Working Group, those are going to be knocked out. However, the risk of nonpayment is credit risk, and there is not much more to it. When it comes to other risks of investing, and this is something that Reis referred to, there was a study of risks of individual investments, and credit risk is certainly one of those. The Capital Adequacy (E) Task Force will probably tell the Valuation of Securities (E) Task Force that is at the heart of what they would need. There is also call risk, and call risk could be identified. This could be very significant in the future. Coming off a high interest rate environment, it would be a negative thing for insurers to have their bonds called away as rates go down. Perhaps Subscript S could be used to indicate call risk. It is not credit risk, but it could be material. Currency risk is another way Subscript S could be used. If it could be identified that Subscript S one or Subscript S two indicates that there is currency risks, an examiner looking through a statement could see that there is a risk of currency. Something that may be more difficult is liquidity risk. Liquidity risk would be very interesting on a bond-by-bond basis. If an examiner were looking at the overall liquidity needs of an insurer, and if they had great liquidity needs, then their assets should match that. The issue with a Subscript S for liquidity is the problem of coming up with a measure of liquidity. The SVO, according to its budget, looks at about 12,000 to 13,000 bonds, but for the rest of the universe, it might be hard to find liquidity. The other measures—extension risk, leverage, and event risk—are relatively hard to come up with a Subscript S, but there needs to be a consensus as to what the core of a definition is. If the Capital Adequacy (E) Task Force is looking at a simple definition instead of complicated P&P Manul language, it would probably come close to credit, but that is the Task Force's call. As for Subscript S, there is a use for it; it is not credit, but perhaps it can be used for other purposes such as call, currency, and maybe liquidity.

Mears said following the lead of the ACLI and the various trade groups included on their letter, and talking separately about Subscript S versus the broader NAIC designation definitions, she has been a big proponent of the type of information that Subscript S has to offer for some time, and she has used deferred interest or payments in kind as an example of that. It is an example of the type of information that the SVO has the tools to identify via the multitude of filings that come its way—i.e., private letter ratings and things like that—where it can really be that type of investment characteristic. That is an example, but it broadly refers to a whole host of investment characteristics that are included under Subscript S, as it was written in this proposal and probably ones beyond that as well. State insurance regulators have an interest in this information. Many recognize that it is not always going to result in the need to change the NAIC designation. For example, as Reis noted, if a company has a concentration in assets that can defer payments beyond what would be a normal expected schedule for cash flows, that certainly has implications for cash flow testing. That is the kind of information state insurance regulators would expect to come out of this Task Force with guidance from the SVO and its teams to define where to go from there. For example, a formal letter from the Life Actuarial (A) Task Force of how to incorporate these risks when materiality or exposure is growing is something that could be addressed. The ACLI, the PPiA, NASVA, and the SFA noted in their letter that it may be more of a portfolio risk than an individual investment; regardless, it is certainly imperative that state insurance regulators have a way of receiving this information.

There have been a multitude of comments around the specificity of the Subscript S and what it is supposed to intend, what it actually intends, and what actions or policies are associated with it, and it is a source of confusion. It is understood that if it were in place, it would not be complete because it would be something that would be manually applied by the SVO and then would not necessarily be applicable to all the filing exempt (FE) securities. If state insurance regulators are getting a Schedule D and looking for Subscript S, they would realize that that is not really a representation of the population that has such characteristics as a whole within that insurer. Also, it being a singular letter, it is difficult to say which one of these characteristics it is applicable to. Mears asked for Task Force members' thoughts on the value of having this information shared with state insurance regulators via the Subscript S or to think through more holistic ways of getting this information that fall into normal information sharing that occurs between the SVO and the Task Force and how the Task Force can disseminate to other working groups. For example, payment in kind is something the Life Actuarial (A) Task Force is starting to look at now based on conversations that have occurred within the Valuation of Securities (E) Task Force over the last year or so. Mears said she appreciates the concerns around the Subscript S, and she is not sure it is necessarily fully needed to give the value that the Task Force hoped to get from other directions, including guidance from the SVO of observations that it is making and things the Task Force can discuss internally and then escalate as needed. She asked if Task Force members had any related thoughts to ultimately provide direction back to the SVO.

Andersen said as a reviewer of cash flow testing, that information would be helpful. He said he does not fully understand the pros and cons of this exact approach, but it seems like it is the information that is needed. Mears said it was her sense that that really was not debatable and did not get the sense from interested parties that that is something they had an issue with.

Reis said transparency is not the issue. The issue is the transparency of Subscript S, and that gets further complicated if they all need to be filed and they are going to be notched. That is different than what Mears and Andersen talked about.

Mears agreed and said the Task Force can provide direction to the SVO to consider that and see what kind of revisions could be made to ensure that there are mechanisms for Task Force members and beyond to receive information from an education standpoint, identify emerging characteristics that could pose risk to the regulatory framework as the SVO team sees them, and escalate them to the Task Force or more broadly and put together mechanisms internally to help aggregate them, recognizing that this particular mechanism is not necessarily the most efficient way to do that. Task Force members should consider this and bring any thoughts on the direction they would want back to the Task Force before exposing a different proposal. Second, the definition of a designation itself is an area that is incredibly important and underlies a lot of the discussions that have been had to date as the Task Force talks about working with CRPs, talking about how NAIC designations are different than ratings in what their ultimate purpose is. A rating is created as a measure of credit risk, and it is delivered into the NAIC insurance framework, and in many cases, it is fully appropriate for the NAIC's needs to pass through the NAIC designation process, ultimately to be used for RBC, state investment code restrictions, assumptions, and AAT. However, it is important to realize that the uses of those NAIC designations are different than what a pension plan would use a rating for in terms of measuring asset allocation and from a quality perspective. One of the intents of these definitions is to create that ground level understanding, and that was the feedback that came through some of the comment letters, particularly from Anderson Insights, saying it should start with something very straightforward that really drives what the designation is. Mears said that is the intent. In terms of some of the comments from the ACLI, the PPiA, NASVA, and the SFA of including LGDs, that is a reasonable suggestion. It would be from a consideration standpoint the same way that the tail risk component was because it is talking at a base level and noting that an NAIC designation, when appropriate, would consider the use of an LGD metric versus just the probability of default. It would not necessarily spell out the technical provisions of how the SVO would implement that; that would have to be a separate process. That goes back to the point that this is an underlying foundational definition. Mears encouraged Therriault and the SVO to put together some language that would address that and work with the ACLI, the PPiA, NASVA, and the SFA to see if that aligns with what their expectations would be. Similarly, there were questions on the inclusion of the tail risk component, which was also meant to be a consideration. There were some questions of how that type of attribute would work on a practical basis, and that was not the intent of these designation definitions because it was more based on an understanding of the types of components that would be in an NAIC designation. It was not intended that the Task Force would answer these questions to have a definition in place, but further feedback would be welcomed, as it is reviewed in that context. Lastly, once that is complete, the definition can be brought back to the Capital Adequacy (E) Task Force, and it can be asked informally if the definition is aligned with its expectations and that it fully understands what this definition entails. That addresses to some extent what is in the letters, and it provides some direction back to the SVO to clean up those definitions. That should not result in many major changes to that section, but the SVO can work directly with interested parties to get to some verbiage that makes sense. Catrone agreed with the direction.

Reis said the ACLI, the PPiA, NASVA, and the SFA are happy to work with the SVO. First, there was a lot of debate amongst the constituents about whether there was even a problem. One could argue that probability of default is sort of a subset of LGD, but not the other way around, so it may not change. However, there is a meaningful constituent group that wants to understand if this changes things. As Mears suggested, this is foundational, and change may come later, but the two-step process is a little worrisome to some.

Mears said the Task Force is trying to take a step back and say any future actions, not ones that are already contemplated and not there yet, should be able to look back to a baseline definition of an NAIC designation to understand why those actions would take place. It is not necessarily that this is starting here because there are already steps two, three, and four in terms of policies that are forthcoming. This is trying to take that step back and say here is that foundational basis, and for future actions, whenever they happen, the Task Force would be able to point to this to say where it fits in.

Anderson said he believes that direction is fine. One of the reasons it is important to go to the Capital Adequacy (E) Task Force because that is part of the R1/C1 calculation; first, they look at probability of default, and then there is a charge or a valuation of the LGD. The Task Force might find that that is already baked into how RBC is done. Double counting is not necessarily a problem; it is conservative.

3. Heard a Staff Report on Updates on the Proposed CLO Modeling Methodology and Ad Hoc Working Group

Mears said agenda item number three is to hear updates on the proposed collateralized loan obligation (CLO) modeling methodology and updates from the CLO Ad Hoc Group.

Eric Kolchinsky (NAIC) said there was a meeting of the CLO Ad Hoc Group that morning. NAIC staff suggested adopting a no prepayment and no discount purchase approach. That is memorialized in a memo on the CLO website. Feedback was also requested from interested parties on a setup of scenarios, as well as the probabilities, which is going to be the next step in the process. The process so far has been great, and there has been really good feedback and a good relationship with working parties.

Mears said she has one additional point since that was seemingly still a source of confusion, given the different workstreams in place. She said for this modeling process, the focus is more on the rated notes of the CLO, which would be ultimately assigned an NAIC designation by the process that comes out of this Task Force. However, the Valuation of Securities (E) Task Force is not responsible for setting RBC factors. There were some questions about another hot topic, the residuals of CLOs, or more broadly of other securitizations, which was discussed within the RBC Investment Risk and Evaluation (E) Working Group and how that would be incorporated into this CLO Ad Hoc Group. There is a back-and-forth working with the Working Group, but it is not the Task Force's responsibility to set capital factors. The way residuals are held without an NAIC designation, without a credit assessment associated with those, means that the Task Force would not be setting factors now or in the future. If there is information that comes out of this process, or the American Academy of Actuaries (Academy), which is working with the Working Group, it could feasibly utilize that for informational purposes while going back through findings. It should be very clear that that is not an anticipated output from this process from the Task Force perspective.

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

https://naiconline.sharepoint.com/teams/svovostaskforce/shared documents/meetings/2023/2023-08 summer nm/01-meeting minutes/vost 7.13.23 interim meeting minutes v5 (final).docx

SVO

NAIC
NATIONAL ASSOCIATION OF
INSURANCE COMMISSIONERS

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

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

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

RE: Clarify the meaning of Repurchase Agreement in the Derivatives Transaction Definition for Funds in Part Three of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*

DATE: April 28, 2023

Summary: In 2021 the Task Force adopted amendments to the NAIC Fund Lists section of the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the “Purposes and Procedures Manual”) to provide greater clarity and predictability regarding the acceptable use of derivatives in funds and permit funds greater flexibility in their use of derivatives while maintaining limits on funds’ use of leverage. The SVO now proposes a new amendment to clarify which side of a repurchase agreement constitutes a derivative transaction for purposes of the section.

The definition “Derivatives Transaction” in the Purposes and Procedures Manual was modeled after the SEC definition in Rule 18f-4 under the Investment Company Act of 1940. The Purposes and Procedures Manual definition reads:

> Derivatives Transaction – means: (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument (“*derivatives instrument*”), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; (2) any short sale borrowing; and (3) *any reverse repurchase agreement or similar financing transaction* [Italics added for emphasis].

One purpose of the original amendment was to limit the use of leverage by funds and, therefore, “Derivative Transactions” encompasses instruments pursuant to which a fund may be required to make a future payment of cash or other assets. Likewise, the inclusion of “reverse repurchase agreements” was intended to capture arrangements by which the fund would owe a future cash payment to the counterparty.

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According to the SEC definition in the Rule 18f-4 adopting release, "In a reverse repurchase agreement, a fund transfers a security to another party in return for a percentage of the value of the security. At an agreed-upon future date, the fund repurchases the transferred security by paying an amount equal to the proceeds of the initial sale transaction plus interest." However, according to SSAP No. 103R - Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, "Reverse repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date." The SSAP No. 103R reverse repurchase agreement definition is the opposite of the SEC definition. According to SSAP No. 103, "Repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date." The SAPP No. 103R definition of repurchase agreement matches the SEC definition of reverse repurchase agreement, in which the fund is obligated to make a repurchase payment at a later date.

Recommendation: To maintain consistency between the Purposes and Procedures Manual and SSAP No. 103R and eliminate any misconception that a fund cannot be the purchaser of securities/lender of cash, the SVO proposes the following changes to the NAIC Fund Lists section of the Purposes and Procedures Manual. The proposed text changes to P&P Manual are shown below with additions in red underline, deletions in ~~red strikethrough~~ as it would appear in the 2023 P&P Manual format.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

NAIC FUND LISTS

. . .

REQUIRED DOCUMENTATION, ANALYTICAL PROCEDURES AND ELIGIBILITY CRITERIA

. . .

Definitions

. . .

293. **Derivatives Transaction** – means: (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; (2) any short sale borrowing; and (3) any ~~reverse~~ repurchase agreement under which the fund sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date, or similar financing transaction, irrespective of accounting treatment.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-08 Summer NM/Minutes/Attachment Two-A 2023-006-01 PP Manual Amend - Funds_Repos_v2.docx

Draft Pending Adoption

Draft: 6/12/23

Valuation of Securities (E) Task Force
Virtual Meeting
May 15, 2023

The Valuation of Securities (E) Task Force met May 15, 2023. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Eric Dunning, Vice Chair, represented by Lindsay Crawford (NE); Lori K. Wing-Heier represented by Jeffery Bethel (AK); Mark Fowler represented by Sheila Travis (AL); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone (CT); Michael Yaworsky represented by Ray Spudeck (FL); Dana Popish Severinghaus represented by Vincent Tsang (IL); James J. Donelon represented by Stewart Guerin (LA); Kathleen A. Birrane represented by Matt Kozak (MD); Grace Arnold represented by Fred Andersen (MN); Chlora Lindley-Myers represented by Debbie Doggett (MO); Jon Godfread represented by Matt Fischer (ND); Marlene Caride represented by John Sirovetz (NJ); Adrienne A. Harris represented by Jim Everett (NY); Glen Mulready represented by Diane Carter (OK); Carter Lawrence represented by Trey Hancock (TN); Cassie Brown represented by Amy Garcia (TX); Jon Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays (WA); and Nathan Houdek represented by Amy Malm (WI).

1. <u>Discussed and Exposed a Proposed P&P Manual Amendment to Update the Definition of an NAIC Designation</u>

Mears said the first item on the agenda is to discuss and consider for exposure a proposed *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) amendment to update the definition of an NAIC designation.

Charles Therriault (NAIC) said NAIC designations are explained and defined in Part One and Part Two of the P&P Manual. The drafted amendment proposes consolidating the explanation and definition into Part One of the P&P Manual because they are policies of the Task Force. The amendment includes clarifying the meaning of NAIC designations, including their use, their purpose, and the risks they address.

When the new format of the P&P Manual was adopted on Nov. 16, 2018, and published on April 7, 2019, there were several changes made to simplify the P&P Manual. It has since become apparent that some of those changes have led to the interpretation that there are really two meanings of an NAIC designation. One meaning, found in Part One, is applicable to all securities whether assigned an NAIC designation pursuant to the filing exemption (FE) process or by the Securities Valuation Office (SVO). A second meaning, found in Part Two, is applicable only to securities assigned NAIC designations by the SVO.

It is the SVO staff's view that there is only one definition of an NAIC designation, and that is applicable to whatever manner the NAIC designation is assigned. The revisions proposed in the amendment consolidate the instructions defining an NAIC designation creating a single, uniform definition which includes updates that address questions and concerns raised over the years as to the purpose of an NAIC designation versus credit rating provider (CRP) ratings.

Additionally, the SVO recommends consolidating the current NAIC designation subscript "s" definition for other nonpayment risks in Part Two into the consolidated NAIC Designation section in Part One because the application of the subscript "s" to assign an NAIC designation for other nonpayment risks signifies a change in the meaning of the designation, but it is also the policy of the Task Force. Most of the updates in the amendment involve existing language that was either moved, consolidated, or eliminated due to redundancy.

Draft Pending Adoption

The new text clarifying the regulatory meaning and objectives of an NAIC designation and expansions of existing guidance are highlighted in yellow to try to make that distinction. A clean version is included at the end of the amendment, which removes all the language that has changed location and highlights only the new text in yellow. The SVO recommends exposing the amendment for a public comment period. As the Task Force continues its communication efforts with the Statutory Accounting Principles (E) Working Group and the Capital Adequacy (E) Task Force, the SVO also recommends referrals to those groups.

Chris Anderson (Anderson Insights LLC) said he had some comments and submitted a letter on this topic on Dec. 5, 2022. He said he agreed with staff that an NAIC designation would benefit from clarification, and there should be a single meaning for NAIC designations. He said he also agreed on the need for consolidation. He said he agrees on key points, and simplification is a valid and achievable goal, which was proposed in his letter. He said the appendix of the letter identified numerous examples in the present P&P Manual that referred to NAIC designations as measures of credit risk or credit quality, and the language in that letter was completely consistent with those concepts that are already in the P&P Manual.

What the proposed language does not reflect is that there are such things as other risks of nonpayment. This completely illogical concept found its way into the P&P Manual some years ago. Credit ratings reflect the risk of nonpayment regardless of the reason. That is what credit ratings are: opinions of the risk of nonpayment. Credit analysts are responsible for assessing the likelihood of any possible reason for nonpayment. There are huge numbers of these factors, and they are security specific. Further, they are all incorporated into credit ratings, as that is what credit ratings are. In the past, there may have been valid concerns about whether a payment was promised, but these are being addressed by the Statutory Accounting Principles (E) Working Group, which is devising tighter standards for what constitutes the debt obligation. The proposed P&P Manual language and the Dec. 5, 2022, letter clarify and simplify it by retaining clear definitions. This should be a welcome relief because it proposes deleting redundant and unnecessary language. Anderson requested that the Task Force expose both versions of the proposed language, meaning the staff version and the version in the Dec. 5, 2022, letter.

Mears confirmed that the Dec. 5, 2022, letter was included in the packet, and she said the letter will be part of the exposure.

Malm made a motion, seconded by Clements, to expose the proposed amendment to update the definition of an NAIC designation in the P&P Manual for a 45-day public comment period ending June 30. The motion passed unanimously.

2. Discussed and Exposed a Proposed P&P Manual Amendment Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the FE Process

Mears said the next item on the agenda is to discuss and consider for exposure a proposed P&P Manual amendment authorizing the procedures for the SVO's discretion over NAIC designations assigned through the FE process. This proposal stems from the Financial Condition (E) Committee's new charge that was given to the Task Force to establish the criteria to permit staff discretion over the assignment of NAIC designations. The new charge also aligns with the current Task Force policy applicable to the FE process, which is found in the P&P Manual, Part One, paragraph 80. It states:

The VOS/TF is resolved that the benefit obtained from the use credit rating in state regulation of insurance must be balanced against the risk blind reliance on credit ratings. To ensure the Task Force properly understands the composition and risk of the filing exempt securities population; promote uniformity in the *production of NAIC Designations, reduce reporting exceptions for filing exempt securities and increase the efficiency of this NAIC process, the SVO and SSG (hereafter, the IAO) is charged with administration of the filing exempt process defined in Part Three of this Manual."*

In keeping with these policies and to provide a little bit more history on how the Task Force effectively got here, during the Spring National Meeting, there was a discussion on a proposed amendment for Structured Equity and Funds. That proposed amendment was based on a type of investment the SVO had identified through its review of private letter rating rationale reports, and as the Task Force directed as part of that process, when the SVO finds a significant potential issue, the SVO should bring that issue to the Task Force, along with a proposed solution. The proposal was to remove Structured Equity and Funds from FE.

The response from industry was that scoping was very difficult to do because it was effectively identifying a structure rather than the potential underlying risk that could be embedded underneath. One of the examples given was putting collateralized loan obligation (CLO) combination notes into this type of structure, which subverts the type of regulation that those are already subject to as being non-FE. It was acknowledged that these structures are clearly utilized broadly for many investments that, upon review, would be a valid use of the FE process. The Task Force heard those comments and understood and recognized that scoping can continue to be an issue as the Task Force looks at things that are more embedded in different types of structures, and it is difficult to draw lines around where those need to be without pulling in other types of investments and making that scope much too large. The Task Force directed the SVO staff to draft a distinct process on how it would recommend challenging an NAIC designation that was assigned from a CRP rating in the FE process on more of a case-by-case basis. The request was that the SVO define this in a way that is easily followable; is a well-understood process; acknowledges that, in many cases, there may just be more information needed; and allows a dialog between the insurer and the SVO.

Mark Perlman (NAIC) said to address the current blind reliance on credit ratings, the proposed amendment outlines the process by which a state insurance regulator or SVO staff member can contest an NAIC designation assigned through the FE process that it believes is not a reasonable assessment of the risk of the security for regulatory purposes. Following a notice period and optional appeal by the insurer security owner, the Eligible NAIC CRP Credit Rating or the security's FE eligibility could be maintained or revoked by the SVO in consultation with the appropriate state insurance regulator, if requested. If the final decision is to revoke FE eligibility, the insurer would then have the option of filing the security with the SVO for an assignment of an NAIC designation. An insurer can appeal revocation in a subsequent filing year. In order to limit the SVO's use of this process to only what would be considered truly material differences of opinion, the SVO would only be able to put a security or CRP rating on notice if it determines, based on the information at hand, that the CRP rating used in the FE process is three or more notches different than the SVO's assessment. Additionally, insurers would be allowed to appeal the SVO's initial assessment to ensure due process. Once notice is given to insurers that a security is under review, the insurer would have up to 120 days to appeal the SVO's assessment by introducing additional information and data, as necessary. This 120-day appeal period is similar to the existing one for SVO-assigned NAIC designations. At the request of the Task Force chair, the SVO would provide a report in a regulator-to-regulator meeting of the Task Force, summarizing the Eligible NAIC CRP Credit Ratings and securities removed from FE eligibility over the prior calendar year and the reason for the removal.

Mears said she would add some additional comments based on some preliminary feedback that has been received. When the idea of this concept was introduced at the Spring National Meeting, it was based on discussions of private investments and private letter ratings. One of the initial questions was if this was a broader proposal and would be inclusive of public ratings. If there is going to be an overarching process, which this proposal is introducing and as was discussed at the Spring National Meeting, then it should be consistent across the board to include all of FE. There is currently a red light response with everything removed from FE, or there is a green light response for everything that is allowed for FE. This proposal would be somewhat of a middle ground or yellow light. The use of private letter ratings, or certain types of private structures, may more likely make up some of the transparency questions that have arisen, and there is a reason to dig into those more. However, if something was found that should be challenged, and that challenge was upheld, then that same concept exists in public securities and should be treated consistently. Private letter ratings may be the start of many reviews, but in the end, the Task Force should be agnostic of whether it is a public or private investment.

Second, as this is put out for exposure and interested parties review and provide feedback, that feedback should provide alternatives, where necessary. There may be instances where the process itself makes sense, but perhaps there may be different components, such as the timing, the type of information, or how that due process works, that need changes. If there are specific concerns with any of those steps, please provide alternatives that would address those concerns. Similarly, the Task Force has been talking for some time about how to address some of the securities out there without taking perhaps too expansive of a view by removing investments from FE. This proposal is to address that concern. If there is a better way to achieve that objective and this proposal is not quite there, comments are welcome; however, it is asked that potential alternatives offered are actionable so they can be reviewed. If one agrees or disagrees with this entirely, that could be in the comment letter as well. It is very helpful when actionable feedback is received. Given the importance of this topic, this will be exposed for a 60-day public comment period and discussed again at the Summer National Meeting in August.

Martin Carus (Martin Carus Consulting LLC) said he is a policyholder, an investor in insurance companies, and a taxpayer. He noted that there is a proposal on the table but no indication of its cost. He asked what this is going to cost and how policyholders are going to benefit. He said there is no cost laid out, and there are no benefits there. It was indicated that this was a very important matter. Carus said he did not see this as a very important matter because he did not see any benefit coming from it. He wondered why this proposal needed to be made at all. FE has been around for a couple of decades, and it has not been a problem. Carus said he has not heard of any company, in any way of its investments, going broke or having its risk-based capital (RBC) materially or even slightly overstated by using the FE process.

Mears said this is something the Task Force has been talking about for quite a bit of time. It is more expansive than just the Task Force. More broadly, there has been a fairly sizeable strategic shift in investments, probably in reaction to a lot of things that the investment managers can speak to, that have driven insurers to more private assets, with the benefit of taking on some more liquidity risk or potential complexity risk, to garner additional returns for insurers that then get passed on to policyholders. That is ultimately beneficial. On the other side, the NAIC's framework, across the board, was not designed for the complexity of these investments or the magnitude at which they are being held. One example is structured securities, which is being addressed elsewhere outside of this proposal. Speaking to some of the broader initiatives that are in place, regulations, as a standard, are always very reactionary. State insurance regulators are not innovators, and they are not going to be proactive. The role is to observe shifts within the market where different materiality increases and then address those issues.

Carus asked how this is going to affect the market if the investor cannot be sure of what they are going to get because the SVO comes in and says that this is now going to be taken out of FE. He asked what that is going to do to the investment marketplace. He also asked whom he is supposed to trust if he is dealing with an insurance company - the SVO's judgment as to whether something is too complicated or not evaluated as to its risk appropriately or the industry and the rating agencies that employ a hundred times or a thousand times as many investment analysts that are credentialed to do that. Carus said this is a way for the SVO to gum up the works in the investment marketplace, and he does not see anything wrong with the FE. If investments come along that are so complicated, there is always a dialogue between the industry and the investment community, and the SVO lays it out for them.

Draft Pending Adoption

Mears said she would welcome a comment letter from Carus. She said this proposal is a reaction to those same concerns, and there is a dialogue in place as each of these is identified. Currently, when the Task Force tries to do it at a higher level, it creates scoping concerns. Due to the Task Force's efforts, this works as a middle ground to help state insurance regulators further understand where potential issues may arise. It is appreciated that many investors and insurance companies are doing a fantastic job in trying to find returns for their policyholders in a way that is measured, but there are instances where that is not the case. There was an example of a liquidation that occurred due to a lack of transparency in their private investments and how those were designated.

Carus asked if that was a single case, and he added that, from a market perspective, that single case had absolutely zero impact on the marketplace. Mears said it did have an impact on those policyholders, and she would welcome the comment letter.

Spudeck asked Therriault if commercial mortgage-backed securities (CMBS) were at one point FE. Therriault confirmed that they were, and he said residential mortgage-backed securities (RMBS) were also once FE. Spudeck asked Therriault if he believes there might have been a capital hit on the broader industry as a result of the financial crises in 2008, 2009, and 2010. Therriault said it was quite substantial at the time. Spudeck asked if this could have been addressed through this proposed framework. Therriault said yes.

Mears said, as noted and observed here, it is expected that there will be a variety of comments on this proposal, and she would appreciate alternatives provided when feasible.

Andersen said he had a few specific points on the question of whether this should be exposed for comment in its present form, and they relate to the objectives, practicality, and environmental, social, and governance (ESG) concerns. The proposal makes references to reasonable assessments of the risk of a security for "regulatory purposes." The meaning of credit ratings is clear and well-defined, whereas the risk for regulatory purposes is definitely not well-defined or well-understood. It is inappropriate to use that as the standard to "challenge" the ratings of nationally recognized statistical rating organizations (NRSROs), which is being proposed here. Credit ratings indicate what staff have been calling the risk of nonpayment; i.e., nonpayment for any reason. That is a regulatory concern when it comes to bonds' nonpayment. A credit rating should be accessed based on what it is: an opinion of relative creditworthiness. Further, NAIC designations are what FE ratings become. The ratings are intended to be used as measures of nonpayment risk, and they are uniform with C1 and R1 RBC factors. The R1 and C1 RBC factors are based on credit history, so it is unreasonable to attempt to use standards other than credit risk to determine NAIC designations.

Andersen's said that he questions the practicality of what is being proposed here. Specifically, the NAIC's Investment Analysis Office (IAO) has proposed three methods for implementing this proposal. There has been no demonstration that any of them will be able to indicate whether the assessments of the NRSROs are accurate.

Andersen (MN) made a motion, seconded by Stolte, to expose this proposed amendment authorizing the procedures for the SVO's discretion over NAIC designations assigned through the FE process for a 60-day public comment period ending July 14. The motion passed unanimously.

3. Discussed a Proposed Amendment to Clarify the Meaning of Repurchase Agreements in the Derivates Transaction Definition for Funds in Part Three of the P&P Manual

Mears said the next item on the agenda for exposure is the proposed amendment to clarify the meaning of Repurchase Agreements and the Derivate Transaction definition for funds in Part Three.

Draft Pending Adoption

Perlman said in 2021, the Task Force adopted amendments to the NAIC Fund Lists section of the P&P Manual to provide greater clarity and predictability regarding the acceptable use of derivatives in funds and permit funds greater flexibility in their use of derivatives while maintaining limits on funds' use of leverage. The SVO now proposes a new amendment to clarify which side of a repurchase agreement constitutes a derivative transaction for the purposes of the section.

The definition of Derivatives Transaction in the P&P Manual was modeled after the U.S. Securities and Exchange Commission (SEC) definition in Rule 18f-4 under the Investment Company Act of 1940. The P&P Manual definition reads:

> *Derivatives Transaction – means: (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; (2) any short sale borrowing; and (3) any reverse repurchase agreement or similar financing transaction.*

The original amendment was intended to limit the use of leverage by funds; therefore, Derivative Transactions encompass instruments pursuant to which a fund may be required to make a future payment of cash or other assets. Likewise, the inclusion of reverse repurchase agreements was intended to capture arrangements by which the fund would owe a future cash payment to the counterparty.

According to the SEC definition in Rule 18f-4 adopting release, "In a reverse repurchase agreement, a fund transfers a security to another party in return for a percentage of the value of the security. At an agreed-upon future date, the fund repurchases the transferred security by paying an amount equal to the proceeds of the initial sale transaction plus interest." However, according to *Statement of Statutory Accounting Principles (SSAP) No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, "Reverse repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date." The SSAP No. 103R reverse repurchase agreement definition is the opposite of the SEC reverse repurchase agreement definition. According to SSAP No. 103R, "Repurchase agreements, not reverse repurchase agreements, are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date." The SAPP No. 103R definition of a repurchase agreement, therefore, matches the SEC definition of a reverse repurchase agreement, in which the fund is obligated to make a repurchase payment at a later date.

To maintain consistency between the P&P Manual and SSAPs, and to eliminate any misconception that a fund cannot be the purchaser of securities/lender of cash, the SVO proposes changing "reverse repurchase agreement" to "repurchase agreement" in the derivatives transaction definition.

To be clear, it is not intended to change the meaning. It is just that the same side of the transaction was named differently by the SEC and SSAPs, and the SVO wants to be consistent with the SSAPs. Subsequent to posting this amendment, Julie Gann (NAIC) explained that pursuant to both statutory accounting and U.S. generally accepted accounting principles (GAAP), many repurchase agreements are treated as secured borrowings rather than derivatives. To eliminate any confusion that the definition of derivative transaction in the P&P Manual Funds List section might be driven by accounting treatment, the SVO also recommends inserting a clause at the end of the posted proposed definition so that it reads: "(3) any repurchase agreement under which the fund sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date, or similar financing transaction, irrespective of accounting treatment."

Mears said this is primarily a technical type of change, but it was done in consultation with the Statutory Accounting Principles (E) Working Group staff to ensure that the definitions were aligned.

Kozak made a motion, seconded by Doggett, to expose the proposed amendment to the P&P Manual to clarify the meaning of repurchase agreements in the derivates transaction definition for funds with the additional language proposed for a 45-day public comment period ending June 30. The motion passed unanimously.

4. Received Updates on the Proposed CLO Modeling Methodology and Ad Hoc Working Group

Mears said the next agenda item is to receive an update on the proposed CLO modeling methodology and any actions and discussions from the CLO ad hoc group.

Eric Kolchinsky (NAIC) said there have already been two meetings of the ad hoc group, and cash flows were shared and discussed for six transactions. Tie-out calls were also held on calls and via numerous email exchanges with several parties that have been involved and which were very helpful.

The next meeting is scheduled for Wednesday, May 17, to discuss some of the issues raised during the tie-out and present cash flows with prepay and discount purchase assumptions. More details will be added to the previously released cashflows, which will help the parties to tie out.

5. Discussed Other Matters

Mears said there was one other matter, and she asked Therriault to provide that update.

Therriault said he wanted to alert the Task Force that the SVO is looking at making a change to how its fees are determined. This is something that has been worked on for at least seven years. Currently, there is a fee for the insurers to file a security with the SVO and then an additional fee to access the NAIC designations assigned by the SVO and the FE process in Automated Valuation Service Plus (AVS+). This can be unfair to insurers that frequently file securities with the SVO. The insurers that do not file with the SVO get the benefit while not sharing the cost. This is an attempt to make it a fairer and more equitable process, as well as more operationally efficient. The concept would be a fee structure based on the book/adjusted carrying value (BACV) of the insurer's Schedule D assets. The fee would cover both the filing of securities with the SVO in Vision and access to the resulting NAIC designation in AVS+. The operational efficiency would be accomplished by the NAIC and insurers not having to process the many invoices produced as the SVO bills for the roughly 12,000 transactions reviewed each year. This is in the preliminary stages, but it can hopefully be included in the 2024 budget and be effective for 2025.

The Executive (EX) Committee must formally consider the proposal and approve any changes, as it and the commissioners as part of the Plenary, are responsible for approving the NAIC budget, which helps the NAIC to better support the nation's chief insurance regulators, as well as the fees charged and the services and functions provided. This is mentioned so the Task Force is aware of this possible change just in case any questions come up about any SVO fee change during the 2024 budget discussions that will begin in the next couple of months. Overall, this change is expected to be revenue neutral from an NAIC budgeting perspective, but the impact on individual insurers could vary, as some insurers may pay no SVO filing fees today but directly benefit from those insurers that frequently file with the SVO and pay the associated fees. Again, a formal proposal will need to be submitted to the Committee and go through its review and approval process before changes can be made.

Draft Pending Adoption

Mears asked if this would remove any sort of variable cost to an insurer based on the number of filings. Therriault said the proposal would replace the vast majority of filing fees, but some fees would still persist, such as the Qualified U.S. Financial Institution List, regulatory treatment analysis service, appeals, and other similar fees. The majority of the SVO fees would be covered by this overall fee that gives access to AVS+ and filing with the SVO.

Mears said to clarify, the Task Force has no oversight over the fee structure whatsoever, but this was meant to provide information to those states that are involved in other processes.

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

https://naiconline.sharepoint.com/teams/svovostaskforce/shared documents/meetings/2023/2023-05-15 interim meeting/minutes/vostf 5.15.23 interim meeting minutes v8 (final).docx

Draft: 7/25/23

2024 Proposed Charges

VALUATION OF SECURITIES (E) TASK FORCE

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

Ongoing Support of NAIC Programs, Products or Services

1. The **Valuation of Securities (E) Task Force** will:

A. Review and monitor the operations of the NAIC Securities Valuation Office (SVO) and the NAIC Structured Securities Group (SSG) to ensure they continue to reflect regulatory objectives.

B. Maintain and revise the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to provide solutions to investment-related regulatory issues for existing or anticipated investments.

C. Monitor changes in accounting and reporting requirements resulting from the continuing maintenance of the *Accounting Practices and Procedures Manual*, as well as financial statement blanks and instructions, to ensure that the P&P Manual continues to reflect regulatory needs and objectives.

D. Consider whether improvements should be suggested to the measurement, reporting and evaluation of invested assets by the NAIC as the result of: 1) newly identified types of invested assets; 2) newly identified investment risks within existing invested asset types; or 3) elevated concerns regarding previously identified investment risks.

E. Identify potential improvements to the credit filing process, including formats and electronic system enhancements.

F. Provide effective direction to the NAIC's mortgage-backed securities modeling firms and consultants.

G. Coordinate with other NAIC working groups and task forces—including, but not limited to, the Capital Adequacy (E) Task Force, the Statutory Accounting Principles (E) Working Group, ~~and~~ the Blanks (E) Working Group and Risk-based Capital Investment Risk & Evaluation (E) Working Group—to formulate recommendations and to make referrals to such other NAIC regulator groups to ensure expertise relative to investments, or the purpose and objective of guidance in the P&P Manual, is reflective in the guidance of such other groups and that the expertise of such other NAIC regulatory groups and the objectives of their guidance is reflected in the P&P Manual.

H. Identify potential improvements 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.

I. 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.

J. 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.

K. Implement additional and alternative ways to measure and report investment risk.

NAIC Support Staff: Charles Therriault, Marc Perlman

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-08 Summer NM/Minutes/Attachment Three 2023-007.01 VOSTF_Proposed_2024_Charges.docx