ROLL CALL

Robert H. Muriel, Chair  Illinois  Chlora Lindley-Myers  Missouri
James J. Donelon, Vice Chair  Louisiana  Bruce R. Ramge  Nebraska
Lori K. Wing-Heier  Alaska  Marlene Caride  New Jersey
Ricardo Lara  California  John G. Franchini  New Mexico
Andrew N. Mais  Connecticut  Linda Lacewell  New York
Trinidad Navarro  Delaware  Glen Mulready  Oklahoma
David Altmaier  Florida  Jessica Altman  Pennsylvania
Dean L. Cameron  Idaho  Kent Sullivan  Texas
Doug Ommen  Iowa  Todd E. Kiser  Utah
Vicki Schmidt  Kansas  Scott A. White  Virginia
Al Redmer Jr.  Maryland  Mike Kreidler  Washington
Gary Anderson  Massachusetts  Mark Afable  Wisconsin

NAIC Support Staff: Charles A. Therriault

AGENDA

1. Consider Adoption of its October 31, September 5, and Summer National Meeting Minutes  Attachment One
   —Kevin Fry (IL)

2. Hear a Staff Report on Projects Before the Statutory Accounting Principles (E) Working Group  Attachment Three
   —Kevin Fry (IL) and Julie Gann (NAIC)

3. Receive a Non-substantive Proposed P&P Manual Amendment to Reflect the U.S. SEC’s Adoption of a New Rule to Modernize Regulation of Exchange-Traded Funds  Attachment Four
   —Kevin Fry (IL) and Marc Perlman (NAIC)
   (Doc ID: 2019-007.01)

4. Consider Adoption of a Substantive Proposed P&P Manual Amendment to Add Instructions for Ground Lease Transactions  Attachment Five – A
   —Kevin Fry (IL), Charles Therriault (NAIC) and Marc Perlman (NAIC)
   (Doc ID: 2019-014.01)

5. Receive a Substantive Proposed P&P Manual Amendment to Remove the Financial Modeling Instructions for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designation and NAIC Designation Categories for these Securities  Attachment Six
   —Kevin Fry (IL) and Charles Therriault (NAIC)
   (Doc ID: 2019-016-01)

6. Receive an SVO Staff Report on the Updated Definition of Principal Protected Securities  —Kevin Fry (IL) and Charles Therriault (NAIC)

7. Receive an IAO Staff Report on the Infrastructure Investments Study  —Eric Kolchinsky (NAIC)
8. Hear Staff Reports on Projects
   — Charles Therriault (NAIC)
     • Status of the Application of the Japan Credit Rating Agency, Ltd. to Be a Vendor of Credit Ratings to the NAIC
     • Status of Efforts to Implement Carry-Over Procedure in 2019
     • Integration of Securities Identifiers in the Filing Exempt Process (BECRS/GICRS)
     • Report on the Implementation of CRP Data Feeds for Securities Subject to Private Rating Letters Component of Filing Exemption

9. Adjournment

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The Valuation of Securities (E) Task Force met via conference call Oct. 31, 2019. The following Task Force members participated: Robert H. Muriel, Chair, represented by Kevin Fry (IL); James J. Donelon, Vice Chair, represented by Stewart Guerin (LA); Ricardo Lara represented by Kim Hudson (CA); Andrew N. Mais represented by Kathy Belfi (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Ray Spudeck (FL); Doug Ommen represented by Carrie Mears (IA); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); Gary Anderson represented by John Turchi (MA); Al Redmer Jr. represented by Matthew Kozak (MD); Chlora Lindley-Myers represented by John Rehagen (MO); Bruce R. Ramge represented by Lindsay Crawford and Justin Schrader (NE); Marlene Caride represented by John Sirotetz (NJ); Linda A. Lacewell represented by James Matheson and Jim Everett (NY); Kent Sullivan represented by Jamie Walker (TX); Todd E. Kiser represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Patrick McNaughton (WA); and Mark Afable represented by Randy Milquet (WI). Also participating were: Howard Liebers (DC); and Matt Kozak (MD).

1. Received a Non-Substantive Proposed P&P Manual Amendment to Add Instructions for ETFs that Contain a Combination of Preferred Stocks and Bonds

Mr. Fry said this agenda item is a proposed non-substantive amendment to add instructions for exchange-traded funds (ETFs) that contain both preferred stocks and bonds. The current instructions permit the Securities Valuation Office (SVO) to consider for inclusion on the bond or preferred stock list ETFs that predominantly only invest in one or the other security type. This amendment proposes permitting an ETF that invests in both preferred stocks and bonds to be included on the preferred stock ETF list. This leads to issues of classification in a situation in which it holds 75% preferred stock and 25% bonds. Derivatives are also permitted up to certain levels, called speculative risk, and above that level it is ineligible. Mr. Fry suggested combining these issues into an SVO paper.

Charles Therriault (NAIC) said that it was a good description of the concerns and the issues. The SVO keeps the list fairly pure, and if there is any excess outside the definition of predominantly bond or preferred stock, the ETF will be rejected.

Mr. Everett said the U.S. Securities and Exchange Committee (SEC) guidance has been as low as 65% in fund guidance of whatever the title might indicate, which is what is tied into the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual); the title of the fund should reflect what is in it. He asked what is being used now to determine what predominately is and what percentage of funds are permitted for derivatives, and how that percentage is calculated.

Mr. Therriault said that is not a hard-set limit, but the SVO looks at what the ETF strategy is, how those instruments are being used to achieve bond like performance, and if it is consistent with what the SVO considers a portfolio of bonds. Generally, there is a very minor percentage of derivatives overall; the exposure is based on market value. Funds should not have any embedded leverage.

Mr. Everett asked if it is the market value as of the date of the valuation or if the percentage of the fund that is set out in the offering is circular. Mr. Therriault said the typical process looks at multiple quarters of historical holdings, and it is the market value as of those quarter ends.

Mr. Fry said that while the SEC may have a limit of 65%, the SVO would be uncomfortable approving a fund with such a low concentration. Mr. Therriault said the SVO expects “predominant” to mean a portfolio with a very high percentage invested only in bonds.

Mr. Everett asked when speaking about derivatives, if it is limited to only the three types that are permitted in the Statements of Statutory Accounting Principles (SSAP) that are limited to income generation, hedging etc., and what kinds of derivatives are being considered in the universe of these. Mr. Therriault said that different types of derivative instruments may be used. The SVO looks at what derivative instruments are used, how they are used to achieve the fund objective, and the strategy that it performs as a portfolio bond.
Mr. Kozak said that he has seen confusion with insurers reporting a U.S. issued ETF with the underlying investments being non-U.S. based. Mr. Fry agreed and believes that a separate schedule may be needed for fund investments.

Mr. Fry directed SVO staff to prepare a memorandum working with the Statutory Accounting Principles (E) Working Group staff summarizing the issues discussed to classify an ETF.

2. Received a Non-Substantive Proposed P&P Manual Amendment to Rename the U.S. Direct Obligations/Full Faith and Credit Exempt List to the U.S. Government Fund List and Discontinue the Bond Fund List

Mr. Fry said the SVO maintains the following two fund lists: the U.S. Direct Obligations/Full Faith and Credit Exempt List and the Bond Fund List. The title of the first list is lengthy and sometimes confusing; this amendment proposes shortening it to the NAIC U.S. Government Money Market Fund List.

The second list, called the Bond Fund List, comprises funds that have only U.S. government investments and maintain the “highest market risk rating,” a rating type that is no longer assigned by any rating agency. There are only four funds on this list today, and the proposal is to merge these existing funds that were on the list for 2019 over to the new NAIC Fixed Income-Like SEC Registered Funds List when they come up for renewal in 2020.

Mr. Therriault said the first list is sometimes confusing as to the definition. The idea is to just call it the NAIC U.S. Government Money Market Fund List to make it clearer. For the Bond Fund List, the SVO analysts preparing the list report that there is no longer a “highest market risk rating” available from any of the rating agencies, and they are concerned that no fund may qualify. The Bond Fund List would fit into the NAIC Fixed Income-Like SEC Registered Funds List; and if the Task Force agrees, it can be migrated there.

Mr. Everett said the first list was prepared on an explicit backing by the U.S. government of issuances and issuances by Fannie Mae and Freddie Mac if those issuances were backed by the direct power and authority by the U.S. government. He asked if there was some way that the default risks or the weighted average default risks could be looked at for funds of the two different lists. The way the lists were broken down initially when the Task Force adopted this is that they were two fundamentally different types of securities. If the lists are going to be merged, it would seem that they should be merged only if there is a statistical identity between the two types of securities.

Mr. Fry said the U.S. Direct Obligations/Full Faith and Credit Exempt List gets no risk-based capital (RBC). The Bond Fund List would be going away, and it would be included with the other mutual funds. Mr. Therriault said that the U.S. Direct Obligations/Full Faith and Credit Exempt List is reported on the cash schedule; and the second list, the Bond Fund List, is reported on Schedule D. They do get different reporting treatment, but they are both high quality. There is no “market risk rating” being produced any longer, and the funds on the Bond Fund List would satisfy the criteria for the NAIC Fixed Income-Like SEC Registered Funds List.

Mr. Everett said that being registered with the SEC does not address the quality or default risk of the funds, only that they have made the correct representations. He asked if there was a statistical identity between the two lists that would justify them being joined. Mr. Therriault said that the intent of the proposal was not to combine the U.S. Direct Obligations/Full Faith and Credit Exempt List and the Bond Fund List. The U.S. Direct Obligations/Full Faith and Credit Exempt List would be renamed, this is a title change and the definition remains the same. The Bond Fund List would be migrated to the NAIC Fixed Income-Like SEC Registered Funds List on the stock schedule with the appropriate NAIC designation based upon its underlying investments. Once the Capital Adequacy (E) Task Force decides on the RBC factors for those funds, it would receive that treatment.

Mr. Rehagen made a motion, seconded by Mr. Milquet, to receive and expose a proposed P&P Manual to rename the U.S. Direct Obligations/Full Faith and Credit Exempt List to the U.S. Government Fund List, and discontinue the Bond Fund List and make a referral to Statutory Accounting Principles (E) Working Group for a 45-day public comment period. The motion passed with New York abstaining.

3. Received a Non-Substantive Proposed P&P Manual Amendment to Add Instructions to Limit NAIC Designations to the NAIC Assigned Sovereign Rating

Mr. Fry said item three on the agenda is a non-substantive proposed amendment to the P&P Manual to add instructions limiting all NAIC designations to the NAIC foreign sovereign designation equivalent. This change is being proposed because the current limitation could be interpreted to mean that only NAIC designations assigned by the SVO (as opposed those produced through
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the filing exempt [FE] process) are capped at the NAIC Foreign Sovereign Designation Equivalent List. This amendment addresses the potential interpretation inconsistency by clarifying that all NAIC designations for foreign securities will be capped according to the NAIC Foreign Sovereign Designation Equivalent List published on the SVO’s webpage. This change would ensure consistency and uniformity regardless of how an NAIC designation is assigned and that the NAIC Foreign Sovereign Designation Equivalent List would govern over all NAIC designations.

Mr. Everett made a motion, seconded by Mr. Liebers, to receive and expose a proposed P&P Manual amendment to add instructions to limit NAIC Designations to the NAIC Foreign Sovereign Designation Equivalent List for a 45-day public comment period. The motion passed unanimously.

4. Adopted a Non-Substantive Proposed P&P Manual Amendment to Update the Interim Instructions for Mortgage Reference Securities

Mr. Fry said item four on the agenda is a non-substantive proposed amendment to the P&P Manual to update the interim instructions for mortgage reference securities. This is a group of securities that are residential mortgage backed securities (RMBS) and commercial mortgage backed securities (CMBS), but the SVO gets involved in designating. The amendment provides guidance to insurers on how to assign an NAIC designation to a newly issued or newly acquired mortgage reference security prior to the publication of the annual surveillance data. This change was requested by industry and discussed at the Summer National Meeting where it was exposed for a 30-day public comment period ending Sept. 4. One comment letter was received from the American Council of Life Insurers (ACLI) and the North American Securities Valuation Association (NASVA) in support of the proposal. Mr. Fry asked if anyone from the ACLI or NASVA would like to comment on their letter. Josh Bean (Transamerica, on behalf of the ACLI) submitted a comment letter in support of this clarification. It provides appropriate instructions for reporting entities and appreciation for the time and work on this exposure.

Robin Marcotte (NAIC) noted that the Statutory Accounting Principles (E) Working Group is working on a Form A that will include these securities, and she recommended a referral to the Working Group.

Ms. Mears made a motion, seconded by Mr. Fletcher, to adopt the P&P Manual amendment to update the interim instructions for mortgage reference securities and send a referral to the Statutory Accounting Principles (E) Working Group. The motion passed unanimously.

5. Received a Substantive Proposed P&P Manual Amendment to Add Instructions for Ground Lease Transactions

Mr. Fry said item five on the agenda is a substantive joint proposed amendment to the P&P Manual to add instructions for ground lease financing (GLF) transactions. This is an item that came up in recent credit tenant loan (CTL) discussions when the Task Force decided that CTLs were outside of FE. Certain transactions are like CTLs, but they do not qualify to be a CTL. The SVO has done some good work with industry on finding a treatment for these securities that have historically performed very well. If the Task Force would like to consider this at the Fall National Meeting, it will require a shorter than usual exposure period. Mr. Fry said he would ask Mr. Therriault and Marc Perlman (NAIC) to provide a summary of this proposal.

Mr. Therriault thanked Mr. Perlman, Daniel Favero (Mayer Brown LLP) and David Persky (Nuveen) for all the hard work they put into this proposal, along with others from the industry group. Technical methodologies like this require a lot of research, discussion and brainstorming on different possible analytical and structural approaches. Through this interactive and dynamic process, which was also used to develop the power generation projects methodology, a better end-product for the Task Force, industry and SVO staff has been produced. Assuming that the Task Force and industry agree, SVO staff will continue using this approach for the other lease-based transactions. Mr. Perlman, the SVO’s new Investment Counsel, is going to provide a high-level summary of the proposal.

Mr. Perlman said the SVO considers CTL transactions to be different from ground lease transactions. First, Mr. Perlman explained why the SVO makes this distinction; and second, he outlined the SVO’s proposed approach to analyzing GLF transactions going forward.

In a CTL transaction, the loan is made, primarily in reliance on the credit standing of a highly rated tenant on a long-term lease of the property. Importantly, the SVO can rely on the credit tenant rating because CTLs are generally structured around the terms of the lease which, in its strongest form, require the tenant to perform all or most obligations related to the leased premises and continue to pay rent regardless of what occurs to the premises. These leases are typically called “hell or high water” or “triple net” leases.
GLF transactions, while sharing certain similarities with CTL transactions, differ in several crucial ways. A GLF transaction typically has two components. First, there is a ground lease for up to 99 years, between a ground lessor who owns the land and a ground lessee who leases the land for the purpose of developing it. Second, there is the subleasing of space by the ground lessee or operation of a business in an existing or to-be-constructed building to one or more subtenants under shorter subleases or a business operator under a franchise agreement or other arrangement.

In a GLF transaction, it is often the case that the terms of the ground lease itself (the first leg of the transaction) makes it a “hell or high water” or “triple net” lease. However, because the ground lessee is a special purpose entity, rather than an operating entity, there is no rating agency rating to rely on; there is no credit tenant. To determine whether the ground lessee will have sufficient funds to pay its ground lease obligations, the SVO must look to the rent payments of the subtenants or the operation of the business being conducted on the property.

The SVO, in conjunction with the NAIC Structured Securities Group (SSG), takes the position that the analysis of subleases and subtenants can be more akin to a CMBS analysis than the corporate analysis in a CTL transaction. This is because ultimate payment on the ground lease loan is dependent not on a single credit tenant, but rather on payments by multiple, possibly unrated, subtenants of differing credit profiles pursuant to multiple subleases of differing terms (which are not necessarily “hell or high water” or “triple net”). The SVO also noted that some of the rating agencies which assign ratings to GLF transactions have utilized their CMBS models in their GLF ratings process, but their methodologies and criteria vary widely.

Recognizing that there are variances in how GLF transactions are structured, the SVO proposes amending the P&P Manual to institute a multi-pronged, decision-tree approach to analyzing these transactions. The proposed P&P amendments would include adding GLF transactions as a new asset class and outline the GLF analytic process as follows.

First, the SVO would analyze the ground lease to determine if it meets the P&P Manual CTL criteria (meaning, it is “hell or high water” or “triple net”). The SVO expects most ground leases to meet this test.

Second, if the ground lease meets the CTL criteria, it would be determined whether three or fewer subtenants combined comprise 90% or more of the total sublease payment obligations, whether those subtenants are rated or can be analyzed by the SVO, and whether their subleases each meet the P&P Manual criteria for CTLs. If so, the SVO could, in its sole discretion, analyze the transaction as akin to a CTL, based on the triple-net nature of both the ground and subleases, the limited number of subleases, and the credit profiles of the subtenants. The SVO expects a small fraction of all GLF transactions to fall into this category.

Third, if the ground lease meets the P&P Manual CTL criteria and there are four or more subtenants; the SVO has determined that the transaction does not meet the criteria just explained; or there are no subtenants, but a single operator of a business, the SVO may refer the subleases or the business operation to the SSG for possible financial modeling. If the SSG determines that the subleases or business operation can be modeled, it would analyze the subleases or business operation to determine whether they will provide sufficient cash flow to pay the ground lease rent payments and any additional costs which the ground lessee would be obligated to cover pursuant to the ground lease terms.

Fourth, if the SSG determines that it is unable to model the subleases or business operation, and if the GLF transaction has been assigned a public or private rating by a rating agency, the SVO may use the rating agency analysis provided by the filer to assist the SVO in its own analysis. The SVO’s analysis will be entirely at the discretion of the SVO, and the SVO will be under no obligation to accept the rating agency analysis, conclusions or ratings. The SVO expects most GLF transactions to fall into this final category.

Mr. Perlman concluded with a summary of the proposed GLF amendment to the P&P Manual, and he recommended that this criteria should apply to all GLF securities purchased after Jan. 1, 2020.

Resh Reese (Teachers Insurance and Annuity Association of America—TIAA) and Mr. Persky said they would like to thank the Task Force and SVO staff for the continued engagement with industry on this matter. With respect to the ground lease topic, industry is very appreciative of the efforts and thorough analysis that was put forth by staff in creating and crafting a resolution for both industry and state insurance regulators, and they look forward to continuing to partner with the Task Force and the SVO on all future matters.

John Garrison (John Hancock) said that the framework that was just outlined is a well thought-out and workable solution.
Mr. Everett said that he appreciates the clarity of the materials and summary.

Benjamin Guzman (Catholic Order of Foresters) said that they appreciate all the SVO and Task Force’s hard work on this solution. It is an important asset class. Tom Sargent (Waterway Capital) said that they are also very appreciative of the work it took to develop a very palatable solution. Michael M. Monahan (ACLI) said that the ACLI supports the expedited comment deadline.

Mr. Everett made a motion, seconded by Mr. Kozak, to receive and expose a proposed P&P Manual amendment to add instructions for ground lease transactions and make a referral to the Statutory Accounting Principles (E) Working Group for a 22-day public comment period. The motion passed unanimously.

6. Discussed a Substantive Proposed P&P Manual Amendment for Principal Protected Securities

Mr. Fry said that item six on the agenda is to discuss a substantive proposed amendment to the P&P Manual to update the definition and instructions for principal protected securities. The amendment may benefit from some additional work on the definition and the Task Force may direct the SVO staff to work with industry to refine it and re-expose the amendment at the Fall National Meeting. The idea is to take this class of securities called principal protected notes, sometimes Collateralized Loan Obligation (CLO) Combo Notes, and make them ineligible for FE. The SVO would apply a look-through methodology to capture the regulatory risk. Mr. Fry asked Mr. Therriault to provide an update on the proposal.

Mr. Therriault said that the Investment Analysis Office (IAO), SVO and SSG staff believe that these securities should not be FE. IAO staff also believe that the rating agencies are following their published methodologies, which focus primarily on the contractual payments, particularly the re-payment of principal, but do not believe the rating assigned using these methodologies reflects how the NAIC views risk from a financial solvency perspective.

The concerns voiced in the comment letters focused primarily on four issues. The first issue is one centered upon the resources of the SVO. The NAIC has and does assign resources where it is needed to meet the needs of its members. Mr. Therriault advised the Task Force that policy decisions should not be made based upon resource concerns. The NAIC’s Executive (EX) Committee is charged with that responsibility, and it makes those decisions based upon member needs and industry feedback. As of today, the SVO does not believe that additional resources will be required to analyze this asset class.

Second, there were concerns about assigning a specific methodology to analyze these securities. Summarizing existing P&P Manual instructions, the SVO has reasonable professional latitude to interpret how the instructions and methodologies contained in the P&P manual apply to specific securities, financial products, or differing analytical situations. Factors that may affect how the SVO interprets instructions and methodologies include, but are not limited to, the terms of individual securities, unique features or characteristics of securities, legal or regulatory issues associated with structured transactions, the issuer’s industry, the introduction of a new security type or asset class, and NAIC regulatory objectives. The SVO is expressly authorized to employ any analytical technique that is taught in standard undergraduate and graduate business school financial analysis curriculum and any analytical technique otherwise widely or commonly used by lending officers, securities professionals, or credit rating analysts, despite the lack of an express authorization to use the technique in the P&P Manual. Mr. Therriault said that these existing instructions are being mentioned because these securities can come in a number of forms, and the SVO needs the flexibility and analytical discretion to apply the methodology that it believes is appropriate to the security being reviewed.

The SVO is also authorized in the P&P manual to analyze securities for other non-payment risk and can express this by assignment of an NAIC Designation with a subscript S. SVO staff believe that these securities fall into such a category. State insurance regulators attach certain economic expectations to certain terms used to describe securities or financial instruments owned by insurers and reported as invested assets. This reflects that the regulatory objective is to assess the financial ability of an insurer to pay claims. Any contractual modification of these regulatory assumptions is deemed to create a rebuttable inference that the security or instrument contains an additional or other non-payment risk—albeit one that is sanctioned by the contract—that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is granted significant discretion when assigning an NAIC designation to a security that reflects other non-payment risk.

The proposal requests that the Task Force permit the SVO to apply these existing instructions to this class of securities and reflect these other risks that, while sanctioned by the contract, may result in the insurer not being paid in accordance with the underlying regulatory assumption. Rating agencies, while they may be adhering to their methodologies, do not have these same concerns or responsibilities as the Task Force.
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Nevertheless, the SVO is very likely to apply a variant of the look through weighted average rating factor (WARF) methodology because such a methodology permits the SVO to look at each source of risk. For example, in analyzing a CLO Combo Note, the SVO would look at the underlying securities based on their credit rating provider (CRP) ratings and weight the ratings factor by their balances to generate the overall NAIC designation. However, the SVO would not want to be artificially constrained to only that one methodology.

A third concern was definitional, that additional assets may be pulled in that do not possess the characteristics that are of concern. The SVO agrees that this may be an issue and would be happy to work with the ACLI to refine the definition of these securities in the amendment. There was also concern expressed about the performance assets not being eligible for Schedule D reporting. Any guidance on the admissibility of an asset falls under the NAIC’s accounting standards of the Statutory Accounting Principles (E) Working Group; and as mentioned in the memorandum, the SVO recommends a referral to the Working Group to consider the issue.

The fourth concern related to application of this amendment to only newly acquired securities. The SVO is sensitive to disrupting insurer investing; particularly, near year end. Mr. Therriault said that the SVO recommends that this amendment become effective on Jan. 1, 2020, to avoid any such disruption and provide insurers an ample transition period; however, the SVO does not recommend exempting any securities from this policy because of the potentially significant inherent risks the SVO sees in these securities. When the SVO sees a situation where it does not believe a security’s rating reflects risk from the NAIC’s perspective, the SVO is obligated to bring it to the Task Force’s attention and propose a recommendation to address that risk; the SVO recommends removing this class of securities from FE eligibility.

Mr. Fry said we received comments letters from the ACLI, NASVA, Kroll Bond Rating Agency (KBRA), Security Benefit Life Insurance, Delaware Life Insurance Company, and Guggenheim Life and Annuity Company. He asked if anyone from those organizations wants to make any brief comments.

Mr. Bean said Mr. Therriault did a nice job of outlining the concerns and has already gone down the road of alleviating or addressing some of them. Certainly Mr. Fry’s comments about directing the SVO and industry to work further on the definition and appropriately refine the scope is really the ultimate focus of the ACLI and NASVA as of this point in time. The ACLI and NASVA look forward in continuing to refine that definition and ensure that the scope is appropriate but truly supports the analytical objectives, and they appreciate the opportunity to be part of the process.

Patrick Welch (KBRA) said Principal Protected Notes (PPNs), from a credit risk analysis perspective, are not inherently or always problematic. KBRA provides thoughtful, clear, respected credit rating methodology that addresses the terms of the issue or the issuance. The credit rating addresses the downside credit risk, and the performance asset could return zero and the rating will still hold.

Joseph Wittrock (Security Benefit Life Insurance) said not all PPNs are created equal. If one looks at statutory accounting guidance, if it immediately went to zero, not only will the insurer get all their principal back plus the contractual coupon; but because the risk asset immediately goes to zero, statutory accounting guidance requires an immediate write down and impairment—a direct impact to surplus—of the diminution in value of these PPN assets because of the risk asset going to zero. Mr. Wittrock said he believes that the current accounting guidance already provides significant protection to policy holders because of their requirements to address prospective cashflow when assessing current carrying value on a statutory balance sheet. In regards to the definition, Security Benefit Life Insurance has engaged in multiple conversations with industry participants, as well as the ACLI; it was quite clear that there were many industry participants that were not engaged and elected not to get involved because the definition was not clear or they did not have any PPNs. Depending on how the definition of a PPN ultimately falls, there may be a lot more industry feedback because there may be a quite a number of insurance companies who have PPN exposures. Mr. Wittrock urged the Task Force to consider a definition which provides crystal clarity of what a PPN is versus what a PPN is not, with no qualitative assessment or ambiguity in terms of what a PPN is.

Mr. Fry said this is not being considered for adoption today, and the SVO has already offered to work with the ACLI and whomever else would like to provide input into refining the definition of these securities in the amendment. Hopefully an update will be available to review at the Fall National Meeting.

Mr. Fry said that the last two items can be deferred, having run out of time. One of those deferred items is moving from price breakpoints on RMBS/CMBS securities to assigning a single NAIC Designation independent of the carrying value, a capability that the SSG already has. The idea is to get input on this change, as it would simplify processes. The other item was an update on an SEC adoption. Both can be discussed at the Fall National Meeting.
Having no further business, the Valuation of Securities (E) Task Force adjourned.

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The Valuation of Securities (E) Task Force met via conference call Sept. 5, 2019. The following Task Force members participated: Robert H. Muriel, Chair, represented by Kevin Fry (IL); James J. Donelon, Vice Chair, represented by Stewart Guerin (LA); Lori K. Wing-Heier, represented by Wally Thomas (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kathy Belfi (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Ray Spudek (FL); Doug Ommen represented by Carrie Mears (IA); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); Gary Anderson represented by John Turchi (MA); Al Redmer Jr. represented by Matthew Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Bruce R. Range represented by Lindsay Crawford and Justin Schrader (NE); Marlene Caride represented by John Sirovetz (NJ); Linda A. Lacewell represented by James Matheson and Jim Everett (NY); Glen Muleady represented by Eli Snowbarger (OK); Kent Sullivan represented by Jamie Walker (TX); Todd E. Kiser represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Patrick McNaughton (WA); and Mark Afable represented by Randy Milquet (WI).

1. **Adopted an Updated Amendment to the P&P Manual to Add Instructions for New Administrative Fields “RTS” and “RT”**

Mr. Fry said this agenda item is a referral from the Statutory Accounting Principles (E) Working Group requesting the Task Force add new reporting codes for investments that meet the definition of a regulatory transaction within the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). Given the P&P Manual restrictions in reporting NAIC designations for regulatory transactions, the Working Group noted that there was no reporting mechanism to identify regulatory transactions or a Securities Valuation Office (SVO) analytical value for risk-based capital (RBC) assessment on the investment schedules.

Charles A. Therriault (NAIC) said the Task Force discussed this referral and amendment at the Summer National Meeting on Aug. 4. At that time, industry had requested some language clarifications and inclusion of needed administrative symbols. The Task Force agreed and directed SVO staff to work with industry on these clarifications and administrative updates to the amendment and then re-expose the amendment, after those revisions were made, for a two-week public comment period ending Aug. 30.

Mr. Therriault said given that it is now in September, it is unlikely that Blanks (E) Working Group or insurers can implement these symbol changes by yearend. He said SVO staff recommend that these symbols be optional for year-end 2019 reporting but required as of Jan. 1, 2020. This would include the application of the carry-over administrative symbols “YE” and “IF” for regulatory transaction that were properly filed with the SVO. The amendment highlights in yellow the changes that were made to the amendment since the Summer National Meeting.

Mr. Fry said the Task Force received one joint comment letter from the American Council of Life Insurers (ACLI) and the North American Securities Valuation Association (NASVA). He said they are supportive of the revised proposal and its adoption. Mr. Fry asked if anyone here from the ACLI or NASVA would like to comment on this letter. Joshua Bean (Transamerica), representing the ACLI and NASVA, said they appreciate the opportunity to comment on the proposal and support its adoption as recommended by NAIC staff.

Mr. Everett made a motion, seconded by Ms. Belfi, to adopt the revised amendment adding the new reporting codes for investments that meet the definition of a regulatory transaction within the P&P Manual and make referrals to Blanks (E) Working Group to add these codes to the SVO Administrative Symbol list in the 2020 annual statement instructions. This amendment would be optional for Dec. 31, 2019, annual statement reporting but required effective Jan. 1, 2020. The motion passed unanimously.

2. **Adopted its 2020 Proposed Charges**

Mr. Fry discussed the Task Force’s 2020 proposed charges. He said there was one deletion from its 2019 charges: The implementation of the NAIC designation category was removed as this project is on track and will be implemented in 2020. He also said there was an addition to: “Identify potential improvements to the filing exempt process (the use of credit rating
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provider ratings to determine an NAIC designation) to ensure greater consistency, uniformity and appropriateness to achieve the NAIC’s financial solvency objectives.” This charge is consistent with recent discussions by Task Force on the use of credit ratings.

The Financial Condition (E) Committee manages the work of its various task forces by assigning time periods for any activity that is not an ongoing activity. No new deadlines were proposed in these charges.

Mr. Sirovetz made a motion, seconded by Mr. Thomas, to adopt its 2020 proposed charges and direct SVO staff to provide them to the Financial Condition (E) Committee for consideration. The motion passed unanimously.

Having no further business, the Valuation of Securities (E) Task Force adjourned.
Date: 8/14/19

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Valuation of Securities (E) Task Force

New York, NY

August 4, 2019

The Valuation of Securities (E) Task Force met in New York, NY, Aug. 4, 2019. The following Task Force members participated: Robert H. Muriel, Chair, represented by Kevin Fry (IL); James J. Donelon, Vice Chair, represented by Stewart Guerin (LA); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kathy Belfi (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmairer represented by Ray Spudeck and Carolyn Morgan (FL); Doug Ommen represented by Carrie Mears (IA); Vicki Schmidt represented by Tish Becker (KS); Gary Anderson represented by John Turchi (MA); Al Redmer Jr. represented by Vincent O’Grady (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Bruce R. Range represented by Lindsay Crawford and Justin Schrader (NE); Marlene Caride represented by John Sirovetz (NJ); Linda A. Lacewell represented by James Matheson and Jim Everett (NY); Glen Mulready represented by Eli Snowbarger (OK); Jessica Altman represented by Kimberly Rankin (PA); Kent Sullivan represented by Jamie Walker (TX); Todd E. Kiser represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Patrick McNaughton (WA); and Mark Afable represented by Randy Milquet (WI).

1. Adopted its May 30 and Spring National Meeting Minutes

Mr. Fry said the Task Force met May 30 and April 7. During its May 30 meeting, the Task Force took the following action: 1) received and discussed a referral from the Statutory Accounting Principles (E) Working Group on structured notes and receive a proposed Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) amendment to update the definition and instructions for structured notes; 2) heard a joint NAIC staff and industry report on the project to review existing credit tenant loan (CTL) guidance and possible new guidance on other lease-based transactions; 3) received and discussed a referral from the Statutory Accounting Principles (E) Working Group on regulatory transactions and received a proposed P&P Manual amendment to add instructions for new administrative fields “RTS” and “RT”; 4) discussed a referral to the Blanks (E) Working Group to add an NAIC designation related to the comprehensive fund instructions; 5) discussed a referral to the Capital Adequacy (E) Task Force on the comprehensive fund instructions; 6) received a proposed P&P Manual amendment to remove obsolete modified filing exempt (MFE) instructions; and 7) discussed a referral to the Blanks (E) Working Group on the NAIC designation modifier and NAIC designation category along with the “SVO” administrative symbol.

Ms. Belfi made a motion, seconded by Ms. Walker, to adopt the Task Force’s May 30 (Attachment One) and April 7 (see NAIC Proceedings – Spring 2019, Valuation of Securities (E) Task Force) minutes. The motion passed unanimously.

2. Adopted an Amendment to the P&P Manual to Update the Definition and Instructions for Structured Notes

Mr. Fry discussed a proposed amendment to the P&P Manual to update the definition and instructions for structured notes. This amendment was drafted after a referral from the Statutory Accounting Principles (E) Working Group requesting that the Task Force update its reporting and definition guidance for structured notes. A structured note is defined as an investment that is structured to resemble a debt instrument, where the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due. Structured notes reflect derivative instruments that are wrapped up within a debt structure.

Industry requested that NAIC staff reconcile the language between definition references in Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds and SSAP No. 86—Derivatives. Mr. Fry said that Attachment Three in the packages that were distributed prior to this meeting with the notation “Amended July 15, 2019” reflects this requested change along with a strike out to the 2018 manual, as the Task Force previously adopted the new manual format. Attachment Three-A is the originally exposed amendment, which was exposed for a 30-day comment period ending July 8.

Mr. Fry said the Task Force received two comment letters. The first was a joint comment letter from the American Council of Life Insurers (ACLI) and the North American Securities Valuation Association (NASVA) that requested the language alignment between the SSAP, which is reflected in Attachment Three. Mr. Fry asked if anyone from either group would like to comment. Mike Reese (Northwestern Mutual), representing the ACLI, said the proposed changes in the attachment address the ACLI’s concerns and it is happy with the changes.

Mr. Fry said a joint comment letter from Keith Bell (The Travelers Companies) and Rose Albrizio (AXA Equitable) was also received. He said it was addressed to the Statutory Accounting Principles (E) Working Group, but the Task Force was copied

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Mr. Fry asked if the Working Group had made the revisions to SSAP No. 26R, No. 43R—Loan-Backed and Structured Securities and SSAP No. 86—Derivatives. Julie Gann (NAIC) explained that the revisions for structure notes and SSAP No. 26R, SSAP No. 43R, SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments and SSAP No. 86 to identify they were in scope were adopted at the Spring National Meeting. The item that is being discussed now at the Working Group is guidance for other derivatives in scope of SSAP No. 86. The guidance for structure notes is final.

Ms. Belfi made a motion, seconded by Mr. Schrader, to adopt the proposed amendment to the P&P Manual amendment, as amended on July 15 to delete the definition of structured notes and to make related modifications to the P&P Manual consistent with the changes adopted by the Statutory Accounting Principles (E) Working Group to SSAP No. 26R and SSAP No. 43R for these investments. The motion passed unanimously.

3. Further Revise and Re-expose Amendment to the P&P Manual to Add Instructions for new Administrative Fields “RTS” and “RT”

Mr. Fry discussed a referral from the Statutory Accounting Principles (E) Working Group requesting the Task Force add new reporting codes for investments that meet the definition of a regulatory transaction within the P&P Manual. Given the P&P Manual restrictions in reporting NAIC designations for regulatory transactions, the Working Group noted that there was no reporting mechanism to identify regulatory transactions or a Securities Valuation Office (SVO) analytical value for risk-based capital (RBC) assessment on the investment schedules.

The referral from the Working Groups requested the Task Force to address reporting for regulatory transactions. The P&P Manual defines the term “regulatory transactions” and provides that a domiciliary state insurance department may request SVO or Structured Securities Group (SSG) assistance in the assessment of a regulatory transaction, with the understanding that the state can adopt the SVO or SSG work product as its own, but the determination is a state determination and not an NAIC work product. The Task Force agreed with the Working Group at its May 30 meeting that there was no specific instruction for reporting regulatory transactions and that reporting entities do not have any available reporting options when investment schedules require an NAIC designation. This amendment would add reporting codes for the investment component of regulatory transactions. Under this proposal, a reporting entity would use the code “RTS” when the domiciliary state has received assistance from the SVO or SSG in reviewing a regulatory transaction. In those cases, the code would be reported with the “analytical value” (a new term defined in the amendment) assigned by the SVO or SSG and given to the state. NAIC staff believe there may be some additional administrative symbol combinations that may be necessary, specifically “Z”, “IF” and “YE”, that could be handled in a separate non-substantive amendment to go along with any Blanks (E) Working Group referral. For all other regulatory transactions when the domiciliary state did not ask the SVO or SSG for assistance or those where the SVO or SSG was unable to determine an analytical value for the transaction for the state, the code “RT” would be used. This code would be reported with an NAIC 6 designation for measurement and RBC assessment. These codes would be specific to Schedule D, Part 1 reporting because those schedules require reporting an “NAIC designation” for all securities. A reporting entity may identify a regulatory transaction on other investment schedules, but such other schedules do not require that an NAIC designation be reported.

Mr. Fry said that two comment letters were received. The first letter was from the State of Vermont Department of Financial Regulation (DFR). The DFR noted that a “state regulator must explicitly approve the admittance of the investment security component of a Regulatory Transaction as a permitted or prescribed practice in order for an insurance company to report it as an admitted asset” and that “a state insurance department should be allowed to assess the credit quality of the security component and assign an analytical value, without the assistance of the SVO, during the review and approval of such regulatory transaction.” The DFR also proposed updates to the amendment. Mr. Fry asked if anyone from the Vermont DFR would like to comment on the letter.

Mr. Fry said that is not the Task Force’s practice—due to uniformity, accounting and the whole statutory framework—that an individual state could designate a security that would have regulatory meaning. If it went through the SVO, it would be accommodated in this proposal.

Mr. Fry said there was a second joint comment letter from the ACLI and NASVA. They are supportive of the intent to clarify requirements and reporting options for holdings determined to meet the definition of “regulatory transactions.” They suggested that additional clarity within and among the proposed amendments would be necessary to provide reporting entities a clear path for meeting the requirements and reporting standards envisioned by the Task Force. They proposed some editorial
modifications to reduce potential ambiguities regarding the process for transition and enforcement. Mr. Fry asked if the ACLI or NASVA would like to comment on their letter.

Josh Bean (Transamerica Capital Strategy), representing the ACLI and NASVA, said that they appreciate the Task Force’s attention to this important matter and the opportunity to comment further. He said they have forwarded a joint comment letter outlining three points that they thought merited additional discussion. He said they are fine with walking away with the suggestion regarding an additional administrative code, which was similar to what was proposed in Vermont’s comment letter. Mr. Bean said they appreciate the clarity that a potential additional amendment would achieve to help them work through transition periods and contesting the classification as a regulatory transaction. He said the one area that remains is that they do believe that some of the terminology is very important here as this is a somewhat complicated and confusing process for entities that are reporting entities. Mr. Bean said they would like to see some of the Task Force’s editorial clarification come through in the language to ultimately ensure that the guidance is unequivocally clear, comprehensible and actionable for the reporting entities. This relates to the security component of a regulatory transaction as opposed to the broader term regulatory transaction itself. He requested a little bit of additional time, either through friendly amendments or possibly a very short re-exposure period, where the Task Force can work through those issues with the SVO.

Mr. Fry explained that this is ready to go but that there is slight clean-up that needs to get done. Mr. Fry asked if the Task Force would you like to move this now and then turn around and make some tweaks. He said they know that some administrative symbols still need to be added. Mr. Fry suggested having SVO staff work with the ACLI and industry to propose those clarifying amendments and needed administrative symbols to provide flexibility at year-end and pick this up during an interim call.

Ms. Belfi had a question on timing, as she said she would like to see this implemented sooner rather than later to provide clarity to both industry and state insurance regulators. Mr. Fry said he wants this in place for this year end and if the Task Force goes with a 15-day exposure period to tweak the language a little bit and add a few symbols, the Task Force may make it work better. Mr. Fry asked Charles A. Therriault (NAIC) to comment. Mr. Therriault said that if there is a short re-exposure, with some minor edits, with a September or early October interim meeting, then this amendment could be ready to adopt for this year-end.

Ms. Belfi made a motion, seconded by Ms. Mears, to direct SVO staff to work with industry on clarifying an administrative update to this amendment and then re-expose the amendment, after those revisions are made, for a two-week public comment period. The motion passed unanimously.

4. Received and Exposed a Proposed P&P Manual Amendment to Update the Definition and Instructions for PPNs

Mr. Fry discussed a proposed memorandum and amendment to the P&P Manual from the SVO staff on principal protected notes (PPNs). These are a type of structured note that do not meet the definition discussed in the second agenda item. It is an investment that is structured to resemble a debt instrument, where the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due. The contractual amount to be paid at maturity is not at risk for a PPN. However, not all of the financial risks associated with these securities are being reflected in the credit rating provider (CRP) rating being assigned to them. Mr. Fry said he asked the SVO to prepare this amendment and asked Mr. Therriault to review the memorandum and amendment for the Task Force.

Mr. Therriault said the SVO was seeing more of these structured note transactions come through its filings and raised its concerns to the Financial Regulatory Services (FRS) staff and chairs of this Task Force and the Statutory Accounting Principles (E) Working Group. The uncertain principal repayment version of structured notes has been addressed, but the obscured financial risk characteristics associated with PPNs has not. The memorandum highlighted two common structures for these investments, but there any many other possible variations. The first is the more “traditional” PPN, where there are two assets: 1) a zero-coupon U.S. Treasury bond; and 2) some other performance asset, such as a derivative contract or equity security. The zero-coupon U.S. Treasury, when it is purchased at a discount, will accrete up sufficiently to repay principal at maturity. The CRP rating focuses only on the risk of the zero-coupon U.S. Treasury and ignores the financial risks associated with the performance assets.

Mr. Therriault said that the second example is similar. However, he said the portfolio of the structure devoted towards principal repayment is a rated corporate bond—in this case, a BBB security. The structure pays a small interest payment to the investor, but it is only a small portion of the coupon being paid on the rated corporate bond. The interest difference between the coupon on the corporate bond and the interest paid to the PPN investor is used to accumulate a balance over the life of the transaction—30 years in this example, which is sufficient to repay the principal at maturity. Again, the CRP rating only focuses on the repayment of principal risk and ignores the financial risks of performance assets.
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Mr. Therriault said he believes these structures obscure the overall financial risk of the investment to state insurance regulators because the CRP ratings focus on the repayment of principle, which fails to reflect the financial risk of the performance assets, which is also part of the structure. He said NAIC designation needs to reflect the overall risk of the investment, including the source and nature of the performance asset. Ignoring the overall financial risk artificially gives these investments a highly favorable NAIC designation under the filing exempt (FE) policy. He said that the CRPs are following their published methodology for these investments, but the SVO does not believe that methodology meets the NAIC’s needs. The SVO has existing methodologies to assess the overall risk associated with PPNs and recommends that they be removed from the FE process and have the SVO review them going forward.

Mr. Fry said what is being proposed is remove these from the FE process. They would still be able to be an asset on Schedule D if they are filed with the SVO and the SVO gives them a designation.

Ms. Walker made a motion, seconded by Mr. Fletcher, to receive the P&P Manual amendment to remove PPNs from being eligible for FE and expose it for a 45-day public comment period ending Sept. 20. The motion passed unanimously.

5. Received and Exposed a Proposed P&P Manual Amendment to Update the Interim Instructions for Mortgage Reference Securities

Mr. Fry discussed a proposed P&P Manual amendment to update the interim report instructions for mortgage reference securities. Mortgage reference securities are analyzed by the SSG each year-end. There are currently no instructions in the P&P Manual to assign an NAIC designation to newly issued or acquired mortgage reference securities. This amendment would add interim reporting instructions for mortgage reference securities. Mr. Fry said that the SSG models residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) now and the Task Force applies the breakpoints to that. These securities are kind of a special sub-class issued by Fannie Mae and Freddie Mac. He said that the SSG does not use the breakpoint methodology, but it does use the modeling process to determine their investment risk.

Mr. Garn made a motion, second by Mr. Sirovetz, to receive the P&P Manual amendment to add interim report instructions for mortgage reference securities and expose it for a 30-day public comment period ending Sept. 5. The motion passed unanimously.

6. Adopted a P&P Manual Amendment to Delete Stray Reference to MFE

Mr. Fry said that on Oct. 11, 2018, the Task Force adopted an amendment to delete the MFE provisions from the P&P Manual and directed a referral to the Statutory Accounting Principles (E) Working Group recommending the deletion of the MFE provisions from SSAP No. 43R. Representatives of the ACLI, NASVA and the Private Placement Investors Association (PPIA) identified a reference to MFE in Part Three, Section 1 (b) of the 2018 P&P Manual. This amendment would delete these obsolete MFE provisions from the P&P Manual. When the MFE process was deleted, there was one little piece of the P&P Manual that had a small reference to that process, and this amendment removes that reference.

Mr. Fry said that the Task Force received a joint comment letter from the ACLI and NASVA, and they are supportive of this proposed amendment. He asked if anyone from the ACLI or NASVA would like to comment on the letter. Mr. Bean said, as mentioned in their comment letter, the ACLI and NASVA fully support this proposal and appreciate the Task Force’s attention.

Ms. Mears made a motion, seconded by Mr. Schrader, to adopt this amendment to remove the outdated residual Modified Filing Exempt (MFE) text from P&P Manual. The motion passed unanimously.

7. Heard a Report on the Project to Review Existing CTL Guidance and Possible New Guidance on Other Lease-Based Transactions

Mr. Therriault said a meeting was held with the industry group on June 24 at the SVO’s offices. The industry group subsequently provided SVO staff with several example transaction legal agreements. The SVO has begun reviewing these materials provided but has still not formed an opinion or drafted a recommendation. He said that the SVO is in the process of hiring a new investment counsel and that this has delayed the review of these legal agreements. Mr. Therriault said he recommends that the Task Force issue instructions to insurers to continue reporting these other lease-based transaction as they have done in the past to avoid any disruptions for this year end. The SVO will continue working with the industry group and is appreciative its efforts.

Mr. Fry said many Task Force members are familiar with this issue where they are trying to understand the rules behind CTLs. There was clear guidance in the P&P Manual, but some companies were interpreting a little bit differently. Companies know
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now that a CTL as defined in the P&P Manual has to be filed with the SVO. There are other transactions that do not fit the CTL guidance but have been previously coming in under the FE process. The Task Force is looking at these transactions now, such as ground leases and other structures that have performed very well over the years. My. Fry said that the Task Force should permit insurers to report these securities as they have in the past until the Task Force makes a final decision. He said he hopes that will be by year-end or 2020. He asked if any Task Force members objected to issuing an instruction to insurers to continue reporting these other transactions as they have done in the past until the Task Force makes a policy decision, and there were no objections from Task Force members. Mr. Fry asked Mr. Therriault to include that instruction in the minutes and the meeting summary.

David Persky (TIAA) and Rej Reese (TIAA) thanked the Task Force and SVO staff for the engagement with industry. They said they appreciate all the effort and focus on this matter and look forward to the continued engagement in coming up with a solution—particularly keeping year-end in mind, as well as making sure that they help to provide any examples that the Task Force or SVO staff need to get to that solution.

Mr. Fry said he appreciates everyone’s efforts in working towards a solution.


Julie Gann (NAIC) said this is part of the coordination efforts of the Statutory Accounting Principles (E) Working Group and this Task Force just to highlight a few of the things that the Working Group has done that would be of interest to the state insurance regulators and interested parties of this Task Force.

Ms. Gann said the Working Group adopted four items:

- **Bank Loans Referrals/Collateral Loans** – Although the Working Group is still discussing bank loans in response to the Task Force referral, the Working Group adopted revisions to SSAP No. 21R—Other Admitted Assets pertaining to collateral loans. These revisions clarify that an investment in another SSAP—such as an investment in scope of SSAP No. 26R—does not become a collateral loan in scope of SSAP No. 21R simply because it has been “sweetened” with additional collateral. The Working Group plans to continue discussing bank loans and hopes for a response back to the Task Force in the next year.

- **Affiliated Investments** – The Working Group adopted revisions to SSAP No. 25—Affiliates and Other Related Parties, to clarify the principles for classifying related party and affiliate investment transactions. This guidance clarifies that the mere presence of a nonrelated party intermediary, or the presence of nonrelated party assets in a structure predominantly comprised of related party investments, does not eliminate the requirement to assess and identify the transaction as a related party (or affiliated) arrangement. The guidance requires consideration to be given to the substance of the transaction and the parties whose action or performance materially affects the insurance reporting entity holding the security.

- **Mortgage Loans** – The Working Group adopted revisions to SSAP No. 37—Mortgage Loans to further clarify the exclusion of funds/securities from the scope of the standard (specifically excluding bundled funds) and to clarify what is required to acquire a mortgage loan through a participation agreement.

- **NAIC Designations by Lot** – The Working Group adopted revisions to SSAP No. 43R to clarify that investments with differing NAIC designations by lot (which potentially only occur with financially modeled securities) shall be reported in the aggregate at the worst NAIC designation, or separately by each applicable NAIC designation. The guidance does not permit reporting the weighted average of NAIC designations. It is expected that this will be a limited occurrence with the elimination of modified filing exemption.

Ms. Gann said the Working Group exposed the following four items:

- **Preferred Stock** – The Working Group exposed a proposed issue paper proposing substantive revisions to SSAP No. 32R—Preferred Stock as part of the investment classification project. This issue paper proposes to revise definitions, measurement and impairment guidance for these investments.

- **Rolling Short-Term Investments** – The Working Group exposed revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments to incorporate principle concepts in classifying investments as cash equivalents or short-term investments. The proposed revisions will require long-term investment reporting (complying with long-term investment provisions) for investments that are not expected to be terminated on the short-term maturity date,
items that are renewed/rolled at the maturity date and items that are terminated with reacquisition of the same (or substantially similar asset) within one year of the termination date. In short, it tries to prevent investments from being repeatedly reported as short-term investments. There are specific exclusions to this guidance to avoid unintended consequences for short-term investments that are expected to be regularly renewed and rolled. As such, the proposed revisions would not include any nonaffiliated SSAP No. 26R investments. It would include affiliated SSAP No. 26R investments, all SSAP No. 43R investments and anything that would be reported as a BA investment if not reported as short-term.

- **Equity Instruments in SSAP No. 43R** – The Working Group exposed revisions to SSAP No. 43R to exclude investments with underlying equity investments from scope. This agenda item was drafted initially to capture collateralized fund obligations (CFOs). These are Schedule BA investments—such as joint ventures, private equity investments, hedge funds, etc.—that are put in trust and then issue “securities” that are based on the expected gain from those equity investments. This is basically a repackaging of equity instruments (which would be on Schedule BA) to reflect debt instruments in scope of SSAP No. 43R and reported on Schedule D-1. The exposure has been expanded to capture all instruments that reflect underlying equity investments to ensure such transactions are not captured through other designs.

- **Other Derivatives** – The Working Group re-exposed revisions to SSAP No. 86—without revisions from the prior exposure—on the guidance for reporting “other derivatives.” Other derivatives include all derivative transactions that are not used in hedging, income generation or replication programs. The guidance indicates that these instruments shall be reported at fair value and nonadmitted.

Ms. Gan said the Working Group deferred/discussed the following items:

- **Working Capital Finance Investments** – The Working Group directed NAIC staff to prepare proposed revisions to SSAP No. 105R—Working Capital Finance Investments in response to the Task Force’s referral. These edits will initially only reflect six of the recommendations and will not include the following:
  
  o Lowering the credit quality of the acceptable obligors from NAIC 1 and NAIC 2 to allow NAIC designations of NAIC 3 and NAIC 4.
  o Allowing credit substitution methodology for unrated subsidiaries.
  o Removing the statement that the reporting entity may need to seek approval from the domestic insurance regulator as this is a statement rather than an explicit requirement.
  o Changing the reporting requirements to move the working capital finance investments (WCFIs) from Schedule BA – Other Assets, to Schedule DA Short-Term Investments

  It is anticipated that SSAP No. 105R will be exposed in the interim or at the Fall National Meeting. (Comments can be provided on the edits reflected, as well as the elements not reflected.)

Ms. Gann said the comment deadline for new exposures is Oct. 11.

9. **Heard an NAIC Staff Report on the Impact of RMBS/CMBS Price Breakpoints with the Upcoming Change in NAIC Designation Categories**

Eric Kolchinsky (NAIC) said for model RMBS/CMBS, the NAIC provides a series of breakpoints to companies and then use set designations with the removal of the MFE approach, which is currently the only approach that uses breakpoints to set designations. The consensus on the NAIC staff side is that at some point, the NAIC should align the RMBS/CMBS modeling to provide a single designation. Mr. Kolchinsky said that is something that can be done analytically. However, he said this issue is being raised today mostly because of some of the technical issues and the cost involved potentially of building out a separate system having 20 breakpoints if in the future that system may go away.

Mr. Therriault (NAIC) said that the NAIC recognizes with the expansion to the NAIC designations to NAIC designation categories, 20 additional points exist for granularity. With the individual security of the price breakpoints, that actually has to expand out to 19 columns of price breakpoints that insurance companies will need to ingest within their investment accounting platforms to determine what the designation and designation category will be. He said the NAIC can produce such a file, but there was concern that this will be very expensive for insurance companies. There was also a concern that if state insurance regulators wanted to go to a single NAIC designation analytical answer or modelled answer, this would be a good time to consider the change before insurance companies had to modify their investment platforms to accommodate the new file format.
Mr. Therriault said that SVO and SSG staff are interested in hearing industry feedback and that state insurance regulators desire to move to a single designation on each security.

Mr. Fry said one of the issues is timing. Eventually, the NAIC will go to 20 designation categories and get the bond factors finalized. At the same time in a separate project that the Task Force talked about in the past is modelling RMBS/CMBS securities and using breakpoints, but the Task Force has been hindered in the past to stop using breakpoints. He said the SSG can model these securities and come up with one designation, no matter what price it is held at. There is momentum on that change, and it is just a matter of when to do that. He said it might make sense to just align it up so everything gets an NAIC designation category when the Task Force decides on the final bond factors. The thought is that it would be more efficient for the vendors, and the companies would save a lot of money instead of having to turn around to get to 20 breakpoints and then a year or two later if the Task Force decides to go to a new modeling technique, then further changes will need to be made. It seems that it would be disruptive to industry. My Fry requested NAIC staff to put together a memorandum that the Task Force can look at that encapsulates all these concepts that were discussed.

Mr. Bean said that industry had some of these discussions a couple of years back. He thinks industry will want to sit down and regroup to formulate its thoughts and that he looks forward to seeing the memorandum and working with the SVO and the SSG.

10. Heard an NAIC Staff Report on the “BeSpoke” Securities

Mr. Kolchinsky said as part of the Task Force’s work, it has found a number of securities where the risk is not adequately reported. A number of these securities were held by troubled companies. SVO staff and SSG staff started calling these securities “bespoke.” The term in finance comes from the London financial area, where bankers get their suits done “bespoke.” Likewise, these financial instruments get done for a single client; they are not done for the market. SVO staff and SSG staff are concerned about them because they are not exposed to market discipline.

Mr. Kolchinsky said the best way to introduce bespoke securities is to provide some examples, such as phantom principal (i.e., PPNs). The security held by the insurer has a principal amount of $100. The amounts have been changed for confidentiality reason. It is held at an NAIC 1, and the SVO estimates designation would be an NAIC 5. The security is issued by a trust, which holds $45 of an unrelated publicly rated NAIC 1 bank 30-year note and $55 of unknown and unrated additional assets. The note itself is rate and gets an NAIC 1, and the way you span the $45 of the NAIC 1 bank note to the $100 of NAIC 1 is the interest payments on the phantom note are much less than on the underlying bank note. That interest goes to pay down the principal. That interest payment is not assigned any credit risk. There is phantom interest created by lowering the coupon of the phantom note. There is no market discipline because no investor would accept a lower coupon for the same risk.

Mr. Kolchinsky said that the other example that NAIC staff have seen are where underlie for the bespoke securities are things that are inadmissible or affiliate assets going into the underlyings of these notes. NAIC staff have seen inadmissible assets such as aircraft go into these notes, along with securities that are circular—a couple of securities pointing at each other for credit support is not clear what it is that is providing it. A part of the problem is that these issues cannot be seen from the face securities or from the name of the security. They often have nice, even friendly names, so one has to dig deeper to see the documents and the portfolio to see what is going on in these securities. There are many others, but these were picked because the others cannot be discussed due to confidentiality.

Mr. Kolchinsky said an issuer or an insurer can create one of these securities, get a rating from a CRP—publicly or privately (more likely privately)—and the insurance company can buy it. There is no public scrutiny at all. The focus here is on market scrutiny of the product that is going on an insurer’s balance sheets. The NAIC cannot look into the security. NAIC staff have tried to define these bespoke securities as: 1) not broadly syndicated (i.e., owned by many parties); 2) created by or for one or a few related insurance companies as an investment; and 3) assigned a credit rating by only one NAIC CRP, often via private rating.

Mr. Kolchinsky said the focus here is market discipline. He said that he would like to separate securities that are private and bespoke because the issuer is a private company, but multiple investors compete to make the investment and review the transaction from securities whose terms and structure are deliberately kept private to keep them from being transparent to the market and state insurance regulators. He said that he would like to add transparency that would allow NAIC staff to see inside the security. There are three main challenges in terms of implementation: 1) definitional. Because they are bespoke, all possible variants cannot be defined; 2) locating bespoke securities in insurance company portfolios because no third-party data providers can provide any information on them like they would with other public securities; and 3) resolution. NAIC staff do not have the authority to do anything about these securities if they find them.
Draft Pending Adoption

One of the approaches the SVO and SSG have been thinking about and want to pursue with the Task Force is a “red flag” approach. A lot of these bespoke securities have red flags, but the converse is not true; just because a security has a red flag does not mean that it is bespoke. Some red flag criteria are: 1) rating from a single rating agency; 2) private letter rating; 3) assets backing the security were primarily owned by insurer or affiliates before that transaction and reported differently (i.e., regulatory arbitrage); 4) assets backing the security may not generate bond cash flows (i.e., contractual requirements to pay periodic principal and interests) or they are equity securities; 5) the insurer or affiliated group are the sole investors in security; and 6) the affiliate of company is underwriter or sponsor of the security. The SVO and SSG staff would like to continue working on this framework and if the Task Force agrees, an issues paper will be drafted including a proposed regulatory analysis on how to deal with bespoke securities for a future meeting.

Mr. Fry said that these are hard to describe and as a state insurance regulator are hard to picture. He said that he would like to start with an issues paper and let the SVO work on this behind the scenes and draft something that the Task Force can expose later. He said this was an opportunity to give everyone a notion that this kind of work is coming.

Mr. Everett said he understands from the presentation that there is no idea how spread out these are or how frequent they appear. Mr. Kolchinsky said it is difficult because they are hard to find. They have been commonly found in troubled companies, they are very hard to find. Mr. Everett asked if the companies in which they have been found represent a percentage of the portfolio. Mr. Kolchinsky (NAIC) said it is difficult to say as the NAIC must keep the company confidential. He said it is something NAIC staff can try to look into a part of the research for the issues paper—what they have seen and how much of their assets it represents.

Mr. Therriault said they are quite substantial in terms of what their investments were and as Mr. Kolchinsky mentioned, these are very hard to find. Often, they are privately rated securities. Unless one looks at the legal agreements, the indentures behind them, the transaction detail will not be seen. The name on the Schedule D blanks does not give sufficient information to understand what the risks are within the investment. This is one of the reasons NAIC staff brought the PPN to the Task Force’s attention and why the structured notes definition was adopted by the Statutory Accounting Principles (E) Working Group. Mr. Therriault said that on face value, the securities look like benign assets, but as one digs in, one realizes there is more complexity to them. He said it is important to understand what the risk is.

Mr. Spudek asked if these coming into the system and appearing on Schedule D through the FE process. Previously, these securities would have come through the SVO for review and the SVO could act on them. Mr. Therriault said most of these have become visible to SVO staff because they were filed as a private letter rating. SVO staff are seeing the underlying structure in this analysis, but they still follow the FE process, and SVO staff have no authority or control to change them. The CRP analysis is not required for private ratings and without it, SVO staff would still not know what they were.

Mr. Fry said that as the Task Force does this, it is going to be careful and hit securities unnecessarily. However, he said the Task Force needs to find a way to focus on these securities and correct them in the system.

11. Heard an NAIC Staff Report on the Infrastructure Investments

Mr. Kolchinsky said wanted to notify the Task Force and industry on a Center for Insurance Policy and Research (CIPR)-led effort to create a research project around infrastructure. A request for information about infrastructure and insurance company investments in infrastructure will be sent to the Task Force interested parties list and it will also be on the CIPR’s website. The request asks any industry and any other persons who have information to get involved in this research project.

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

TO: Kevin Fry, 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

CC: Marc Perlman, Investment Counsel, NAIC Securities Valuation Office
    Eric Kolchinsky, Director, NAIC Structured Securities Group and Capital Markets Bureau

DATE: November 15, 2019


1. Introduction – On September 26, 2019, the SEC adopted rule 6c-11 (the “Rule”) under the Investment Company Act of 1940 (the “Act”) which will permit exchange-traded funds (“ETFs”) that satisfy certain conditions to operate without first obtaining an exemptive order from the SEC under the Act. The SEC has stated that the intent of the rule is to modernize the regulatory framework for ETFs by reducing expenses and delays in creating new ETFs, to promote greater consistency, transparency and efficiency for ETFs and to facilitate greater competition among ETFs. The Rule becomes effective December 23, 2019, followed by a one year transition period for compliance.

ETFs contain certain features that distinguish them from the types of investment companies originally contemplated by the Act and its rules and, therefore, have needed to rely on SEC exemptive orders to operate as investment companies under the Act. Current ETF exemptive orders provide relief from: (i) Sections 2(a)(32) and 5(a)(1) which require shares to be redeemable; (ii) Section 22(d) and Rule 22c-1 which require sales of redeemable securities to be at the public offering price and the redemption price to be at current net asset value (“NAV”); (iii) Section 22(e) which requires redemption proceeds to be delivered within seven days; (iv) Sections 17(a)(1) and (2) which prohibit affiliates from selling to, or purchasing from, an ETF; and (v) Section 12(d)(1) which places limits on funds of funds. The new Rule will end the need for exemptive relief for each of these requirements except item (v). Additionally, the Rule permits ETFs to use “custom baskets” which do not reflect a pro rata representation or representative sampling of the ETF’s portfolio holdings and the SEC is rescinding current ETF marketing restrictions.

In order to rely on the new Rule, an ETF must satisfy (i) the new definition of ETF as (a) an open-end management company that issues and redeems creation units to and from authorized participants in exchange for baskets and cash balancing, if any, and (b) which issues shares that are listed on a national securities exchange and traded at market determined prices and (ii) various conditions including: (a) updated website disclosure of holdings and baskets, NAV per share, market price, premiums or discounts, median bid-ask spread, and (b) adoption of policies and procedures that govern the construction and acceptance of baskets, including custom baskets.

The Rule will rescind the exemptive orders from existing ETFs which will be able to rely on the Rule, going forward. However, certain categories of ETF will not be covered by the Rule, including leveraged ETFs, inverse ETFs, ETFs
organized as Unit Investment Trusts (UITs), share class ETFs and non-transparent active ETFs. The SEC expects most ETFs to be covered by the Rule.

2. **Recommendations** – The SVO takes the position that since the Rule primarily affects SEC exemptive relief and ETF reporting and disclosure, it will not impact the quantitative and qualitative factors the SVO considers, in accordance with the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (“P&P Manual”), when analyzing ETFs. As such, the SVO recommends the following non-substantive changes (shown below with strikethrough and underline) to the P&P Manual to remove references to SEC exemptive orders from descriptions of ETFs and clarify that Regulatory Treatment Analysis Service application filers only need to provide SEC exemptive orders to the SVO when applicable.

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**2019 P&P MANUAL**

Part Three – SVO Procedures and Methodology for Production of NAIC Designations

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**Investments in Funds**

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**Directive**

246. The VOS/TF directs that the SVO establish and maintain: the various NAIC Lists of fund investments or compilation processes hereinafter identified; administrative procedures to receive applications of insurance companies and of fund sponsors; procedures to disseminate the Lists to insurance companies and state insurance regulators and analytical criteria and methodology to evaluate fund eligibility. The SVO shall evaluate:

. . .

- Exchange Traded Funds (ETFs) registered with the SEC and operating under Exemptive Orders under the Act that predominantly hold bonds (or preferred stock) (as more fully described below) to determine if they are eligible for inclusion on the SVO-Identified Bond ETF list (reported on Schedule D, Part 1) [or SVO-Identified Preferred Stock ETF List (reported on Schedule D, Part 2, Section 1)].

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**NAIC FUND LISTS**

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**The SVO-Identified Bond ETF List and the SVO-Identified Preferred Stock ETF List**

255. **Description** – At this time, ETFs operate under an Exemptive Order granted by the SEC that provides relief from the application of provisions of the Investment Company Act of 1940 that would otherwise apply. ETFs issue creation units to initial investors in exchange for a specified portfolio of bonds. The initial investor can hold the creation units or sell the ETF shares that constitute the creation unit on the exchange on which the ETF is registered. Other investors may purchase ETF shares; including to reconstitute and redeem a creation unit. Shares of ETF are not redeemable to the fund but are traded on registered exchanges at a price set by the market. Shares of ETFs are expected to trade at or near par because of arbitrage related to the value of the portfolio or of the ETF shares. For inclusion on the SVO-Identified bond ETF list, the ETF must hold a portfolio of bonds (or preferred stock) that tracks a specified bond index (a passive investment) or it a portfolio of bonds (or of preferred stock) that it actively manages pursuant to a specified investment objective.

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Documentation

277. An insurance company or the sponsor of a bond or preferred stock fund that request that the SVO conduct the look through and credit assessment submits the following required documentation to the SVO:

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- In the case of an ETF, copies of the Application, Notice and Order associated with the fund sponsor’s request for Exemptive Relief from the SEC or a link to the SEC’s EDGAR where the SVO can obtain the documents, if applicable.
MEMORANDUM

TO: Kevin Fry, 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, Investment Counsel, NAIC Securities Valuation Office (SVO)
    Catholic Order of Foresters
    CGA Capital
    Mesirow Financial, Inc.
    CTL Capital
    Waterway Capital

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

RE: Joint Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Add Ground Lease Financing Transactions as New Asset Class

DATE: October 17, 2019

1. Introduction – Earlier in 2019 the SVO became aware that certain insurance company filers were submitting credit tenant loan (CTL) transactions and transactions which are herein defined as ground lease financing (GLF) transactions through the Filing Exempt (FE) process. The SVO subsequently explained to the market that (i) all CTL structures must be submitted to the SVO for review pursuant to Part One, Paragraph 106 and Part Three, Paragraph 4 of the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P), (ii) the SVO considered GLF transactions distinct from CTL transactions and (iii) the SVO identified that it would need to study the GLF transactions before they could make a recommendation to the Valuation of Securities (E) Task Force on whether NAIC Designations could be assigned to these structures and if they should be eligible for Schedule D reporting given their credit and legal risks. The SVO has now completed that study and a discussion of the SVO’s evaluation of the GLF asset class, its proposed approach to analyzing GLF transactions, and its recommended related amendments to the P&P follow.

2. Analytic Overview –

Credit Tenant Loans – CTLs are loans made to the owner of real property but made primarily in reliance on the credit standing of the tenant on a long-term lease of such property (generally highly rated by an NAIC CRP), structured with an assignment of the rental payments under such lease to the lender with such real property pledged as collateral in the form of a first lien. CTLs are generally structured around the terms of the lease which, in its strongest form, requires the tenant to perform all obligations related to the leased premises thereby obligating the tenant to continue to pay rent regardless of what occurs to the leased premises (e.g. casualty or condemnation). The leases are typically considered, with certain recognized variants in the P&P, to be “hell or high water” or “triple net” in nature. Therefore, the SVOs analytic focus is on the credit worthiness of the tenant (or its guarantor), and not the
real property characteristics of the premises. As explained in the CTL section of Part Three of the P&P, the SVO recognizes four categories of CTLs as eligible for reporting on Schedule D (Bond Lease Based CTLs, Credit Lease Based CTLs, Acceptable CTL Variants (ACVs), and Multiple Property Transactions (MPTs)), each with varying degrees of landlord obligation and real estate risk exposure and varying legal and structural complexity. Pursuant to the P&P’s CTL criteria, each enumerated permitted landlord obligation or risk must be explicitly addressed with an enumerated mitigant. (CTLs are explained extensively in the P&P, Part Three, Paragraphs 71 – 91.)

Ground Lease Financings – A GLF transaction typically has two components: (i) a ground lease for a long period (e.g. 99 years) between a ground lessor who owns the land and a ground lessee who attains a leasehold for the purpose of developing the land, and (ii) the subleasing of space or operation of a business such as a hotel, warehouse, intermodal facility, etc. in an existing or to-be-constructed building to one or more tenants (space tenants) under shorter (e.g. 5-15 year) leases (space leases) or to the operator of a business such as a hotel, warehouse, intermodal facility, etc. under a franchise agreement or other arrangement.

Both the ground lessor and ground lessee will typically finance their respective estates (i.e., the fee estate of the ground lessor and the leasehold estate of the ground lessee); (i) the ground lessor, typically, with the issuance of debt-like certificates or notes, and (ii) the ground lessee, typically, by borrowing from a financial institution or traditional mortgage lender. To secure the financing, the ground lessor will grant to the lender a mortgage on the fee property such ground lessor owns, and the ground lessee will pledge to the leasehold lender its leasehold estate and its rights under the ground lease and in the improvements which it owns and the space leases if any.

Typically, in a GLF transaction neither the ground lessor nor the ground lessee is an entity either (i) rated by an NAIC CRP or (ii) whose credit worthiness can be evaluated by the SVO. Rather, they are special purpose vehicles (SPVs) intended to be bankruptcy remote.

Comparison of CTLs and GLFs – Due to the “hell or high water” or “triple net” nature of the lease in a CTL transaction or, in the instance where there are variances, their mitigation in accordance with the P&P CTL criteria, the SVO can focus its analysis on the credit worthiness of the credit tenant and not on an analysis of the underlying property. This type of lease eliminates the investor’s exposure to property risk as all payments owed to the investor ultimately come from the tenant.

In a GLF transaction it is often the case that the terms of the ground lease itself (the first leg of the transaction) is structured with the same attributes as a lease in a CTL transaction (e.g. it is “hell or high water” or “triple net”). However, because the ground lessee is an SPV rather than an operating entity, there is no NAIC CRP credit rating or SVO credit analysis to rely on. To determine whether the ground lessee will have sufficient funds to pay its ground lease obligations the SVO must look to the rent payments of the space tenants or the operation of the business being conducted on such property. The SVO, in conjunction with the NAIC Structured Securities Group (SSG) takes the position that the analysis of space leases and space tenants can be more akin to a commercial mortgage backed security (CMBS) analysis than the corporate analysis in a CTL transaction because the space leases may not meet the CTL criteria and can consist of several space tenants of differing credit profiles and each with differing space lease terms. We note that some of the NAIC CRPs which assign ratings to GLF transactions have utilized their CMBS models in their GLF ratings process, but their methodologies and criteria vary widely. The SVO understands that in most GLF transactions the certificate holder, the insurer as the investor, is in a "last loss", or most senior, position. However, regardless of where they stand in the waterfall, unlike a traditional CTL transaction, ultimate payment on the GLF certificates is dependent not on a single credit tenant, but rather on payments by all the space tenants (which are not necessarily NAIC CRP rated or SVO analyzed entities) pursuant to space leases (which do not necessarily meet the CTL criteria).
Proposal – Recognizing that there are variances in how GLF transactions are structured the SVO proposes amending the P&P to institute a multi-pronged approach to analyzing these transactions. The proposed P&P amendments would include adding GLF transactions as a new asset class and would outline our GLF analytic process as follows:

a. The SVO would analyze the ground lease to determine if it meets the criteria for Bond Lease Based CTLs or Credit Lease Based CTLs in the P&P. We expect most ground leases to meet this test. Ground lease inconsistency with the Bond or Credit Lease Based CTL criteria would result in ineligibility for Schedule D reporting.

b. If the ground lease meets the Bond or Credit Lease Based CTL criteria and if three or fewer space tenants, each of which either (i) are rated by an NAIC CRP or (ii) whose credit worthiness can be evaluated by the SVO, when combined comprise 90% or more of the total space lease payment obligations, the SVO would analyze the space leases to determine if they meet the CTL criteria for one of the four CTL categories in the P&P. If so, the SVO could, in its sole discretion and based on its analytic judgement, analyze the transaction as akin to a CTL, based on the CTL-like nature of both the ground and space leases, the limited number of space leases and the credit profiles of the space tenants. We expect a small fraction of all GLF transactions to fall in this category.

c. If the ground lease meets the Bond or Credit Lease Based CTL criteria and there are four or more space tenants, or the SVO has determined that the transaction does not meet the criteria set forth in clause (b.) above or if there are no space tenants but one operator of a business on the leasehold such as a hotel, warehouse, intermodal facility, etc., the SVO may refer the space leases or the business operation to the SSG for possible financial modeling. If the SSG, in conjunction with its third-party modeling vendor, determines that the space leases or business operation can be modeled, the SSG would analyze the space leases or business operation, as the case may be, to determine whether they will provide sufficient cash flow to pay the ground lease rent payments and any additional costs which the ground lessee would be obligated to cover pursuant to the ground lease terms (e.g. taxes, utilities, maintenance, insurance).

d. If the SSG, in conjunction with its third-party modeling vendor, determines that it is unable to model the space leases or business operation, as the case may be, and if the transaction has been assigned an Eligible NAIC CRP Rating, public or private, the SVO may use the NAIC CRP analysis provided by the filer to assist the SVO in its own analysis. The SVO’s analysis will be entirely at the discretion of the SVO, and the SVO will be under no obligation to accept the NAIC CRP analysis, conclusions or ratings. Furthermore, upon completion of its analysis the SVO can decline to assign an NAIC Designation, in which case the security would be ineligible for Schedule D reporting.

e. Insurers that would like the SVO to review the GLF transactions prior to purchasing them may submit them through the Regulatory Treatment Analysis Service (RTAS) process. The SVO is willing to set up new RTAS processes for each of these three paths, at the request of the submitting investor: 1) SVO credit analysis, 2) SSG modeling and 3) SVO review of NAIC CRP analysis.

f. Additionally, the SVO would look for evidence that (i) the transaction is properly insured because, unlike a credit tenant in a CTL transaction, the ground lessee SPV will not have access to extra funds to cover costs such as repairs in the event of casualty, and (ii) that satisfactory Phase I and, if necessary, Phase II environmental reports have been delivered to provide comfort that there will be no expected environmental liabilities.

3. Recommended Amendment – The recommended changes to the P&P regarding the addition of Ground Lease Financing criteria are shown below in red, showing how it will appear in the 2019 P&P format. The SVO recommends that this amendment also be referred to the Statutory Accounting Principles (E) Working Group for affirmation that these investments are eligible for Schedule D, Part 1 reporting under the criteria proposed.
2019 P&P Manual

Part One – Policies of the NAIC Valuation of Securities (E) Task Force

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES


GROUND LEASE FINANCING TRANSACTIONS

GLF Overview

107. A ground lease financing transaction (GLF) typically has two components: (i) a ground lease for a long period (e.g. 99 years) between a ground lessor who owns the land and a ground lessee who attains a leasehold for the purpose of developing the land, and (ii) the subleasing of space or operation of a business such as a hotel, warehouse, intermodal facility, etc. in an existing or to-be-constructed building to one or more tenants (space tenants) under shorter (e.g. 5-15 year) leases (space leases) or to the operator of a business such as a hotel, warehouse, intermodal facility, etc. under a franchise agreement or other arrangement.

108. The ground lease itself typically meets the Credit Tenant Loan (CTL) criteria for Bond Lease Based or Credit Lease Based CTLs in this Manual. Additionally, there can be one or several space tenants or business operators (which (i) may or may not be NAIC CRP rated entities or (ii) whose credit worthiness can or cannot be evaluated by the SVO) making lease payments under separate space leases (which may or may not meet the CTL criteria) or a business operation. As such, the SVO cannot rely solely on the CTL criteria for its analysis of GLF transactions and instead must rely on a combination, as necessary and available, of the CTL criteria, the CMBS criteria, the documented analysis of NAIC CRPs, and the SVOs own analytic judgement.

109. A GLF transaction reported as a CTL on transaction on Schedule D, acquired prior to January 1, 2020, and reported with an NAIC Designation produced under filing exemption, can continue to be reported on the basis of that Eligible NAIC CRP Rating until sold or disposed of.

NOTE: See “Ground Lease Financing Transactions” in Part Three for filing instructions, documentation requirements and methodology applicable to GLFs.

Part Three – SVO Procedures and Methodology for Production of NAIC Designations

PROCEDURE APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL) RATING SECURITIES


FE SECURITIES

Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:

...
• **Ground Lease Financing Transactions** – A Ground Lease Financing (GLF) transaction typically has two components: (i) a ground lease for a long period (e.g. 99 years) between a ground lessor who owns the land and a ground lessee who attains a leasehold for the purpose of developing the land, and (ii) the subleasing of space or operation of a business such as a hotel, warehouse, intermodal facility, etc. in an existing or to-be-constructed building to one or more tenants (space tenants) under shorter (e.g. 5-15 year) leases (space leases) or to the operator of a business such as a hotel, warehouse, intermodal facility, etc. under a franchise agreement or other arrangement. GLF transactions are not eligible for filing exemption. The GLF section in this Part provides further guidance on how the SVO analyzes GLF transactions for purposes of determining Schedule D eligibility and whether the SVO can assign an NAIC Designation.

Part Three – SVO Procedures and Methodology for Production of NAIC Designations

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**Ground Lease Financing Transactions**

**NOTE**: See “Policies Applicable to Specific Asset Classes” in Part One for policies governing this activity, as well as “Specific Populations of Securities Not Eligible for Filing Exemption” in “Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities” above.

**Initial Filing Requirements**

305. For ground lease financing (GLF) transactions, the reporting insurance company shall submit a complete GLF Evaluation Form together with the documentation described in the GLF Evaluation Form and, if available, evidence of a current Eligible NAIC CRP Rating and related NAIC CRP analysis for (i) the GLF Transaction (including, but not limited to rating methodology used, model assumptions and stress test results) and (ii) each space lessee or its guarantor or business operator in the case of a hotel, warehouse, intermodal facility, etc. or other business operation.

**Subsequent Filing Requirements**

306. For GLF Transactions, the reporting insurance company shall submit evidence, if available, of a current Eligible NAIC CRP Rating and related NAIC CRP analysis for (i) the GLF Transaction (including, but not limited to rating methodology used, model assumptions and stress test results) and (ii) each space lessee or its guarantor or business operator. For purposes of this section, a current Eligible NAIC CRP Rating is defined as one issued or reviewed within the past 12 calendar months. If the GLF Transaction is modeled by the NAIC’s third-party modeling vendor, the reporting insurance company will submit the data required by the vendor in the form such vendor specifies. In the event a space lessee or its guarantor or business operator, as the case may be, is not rated by an NAIC CRP and a space lease or business operation is not modeled, the reporting insurance company shall file the Audited Financial Statements and other relevant credit information of the space lessee or its guarantor or business operator, as the case may require, consistent with all corporate bond filing requirements.

**SVO Procedure**
307. Upon receipt of a GLF Evaluation Form, the SVO analyst shall review the form and all documentation submitted with it and shall proceed with analysis in accordance with section “SVO Approach to GLF Transactions” below.

Ground Lease Financing Transaction – Definition and Overview

308. A ground lease financing (GLF) transaction typically has two components: (i) a ground lease for a long period (e.g. 99 years) between a ground lessor who owns the land and a ground lessee who attains a leasehold for the purpose of developing the land, and (ii) the subleasing of space or operation of a business such as a hotel, warehouse, intermodal facility, etc. in an existing or to-be-constructed building to one or more tenants (space tenants) under shorter (e.g. 5-15 year) leases (space leases) or to the operator of a business such as a hotel, warehouse, intermodal facility, etc. under a franchise agreement or other arrangement.

309. Both the ground lessor and ground lessee will typically finance their respective estates (i.e., the fee estate of the ground lessor and the leasehold estate of the ground lessee); (i) the ground lessor, typically, with the issuance of debt-like certificates or notes, and (ii) the ground lessee, typically, by borrowing from a financial institution or traditional mortgage lender. To secure the financing, the ground lessor will grant to the lender a mortgage on the fee property such ground lessor owns, and the ground lessee will pledge to the leasehold lender its leasehold estate and its rights under the ground lease and in the improvements which it owns and the space leases if any.

310. Typically, in a GLF transaction neither the ground lessor nor the ground lessee is an entity either (i) rated by an NAIC CRP or (ii) whose credit worthiness can be evaluated by the SVO. Rather, they are special purpose vehicles (SPVs) intended to be bankruptcy remote.

311. In a GLF transaction it is often the case that the ground lease (the first leg of the transaction) is structured with the same attributes as a lease in a CTL transaction (e.g. it is “hell or high water” or “triple net”). However, because the ground lessee is an SPV rather than a corporate entity, there is no NAIC CRP corporate credit rating or SVO corporate analysis to rely on. To determine whether the ground lessee will have sufficient funds to pay its ground lease obligations the SVO must look to the rent payments of the space tenants or the operation of the business conducted in such improvements (such as a hotel, warehouse, intermodal facility, etc.). Depending on the specifics of a GLF transaction, analysis of space leases and space tenants and business operations and business operators could be more akin to a commercial mortgage backed security (CMBS) analysis than the corporate analysis in a CTL transaction because (i) the space leases may not meet the CTL criteria and can consist of one or several space tenants of differing credit profiles and each with differing space lease terms and ultimate payment on the GLF is dependent on the space tenants making their rent payment on the space leases or (ii) in the event there is a business operation, ultimate payment on the GLF is dependent on the operation of such business to generate cashflow for ground rent and other expenses. For this reason, the SVO may refer certain GLF transaction space lease or business operations analyses to the NAIC Structured Securities Group (SSG) because of the SSG’s financial modeling capabilities and because, in accordance with this Manual, it analyzes and assigns NAIC Designations to CMBS transaction.

SVO Approach to GLF Transactions

312. All GLF transactions are ineligible for filing exemption and must be submitted to the SVO. The SVO will conduct GLF transaction review in the following manner:
a. The SVO will analyze the GLF transaction structure and determine whether the ground lease meets the CTL criteria for Bond Lease Based or Credit Lease Based CTLs, except for not having a credit tenant. If the SVO, in its sole discretion, determines the ground lease does not meet the Bond Lease Based or Credit Lease Based CTL criteria, except for a credit tenant, the security would be ineligible for Schedule D reporting.

b. If the ground lease meets the CTL criteria, except for a credit tenant, and if three or fewer space tenants, each of which (i) are rated by an NAIC CRP or (ii) whose credit worthiness can be evaluated by the SVO, when combined comprise ninety percent (90%) or more of the total space tenant lease obligations, the SVO will analyze the space leases to determine if they meet the CTL criteria for one of the four CTL categories in this Manual. If so, the SVO can, in its sole discretion and based on its analytical judgment, analyze the transaction as akin to a CTL, based on the CTL-like nature (e.g. “hell or high water” or “triple net” features) of both the ground and space leases, the limited number of space leases and the corporate credit profiles of the space tenants.

c. If the ground lease meets the criteria for Bond Lease Based or Credit Lease Based CTLs and there are four or more space tenants, or the SVO has determined that it cannot apply the approach in (b.) above or the transaction does not meet the criteria set forth in clause (b) above, the SVO will refer the space leases or the business operation, as the case may be, to the SSG for possible financial modeling. If the SSG, in conjunction with its third-party modeling vendor, and in its sole discretion and analytical judgment based on factors including, but not limited to, availability of data, transaction structure and other transaction specific risks, determines that the space leases or business operation can be modeled, it will analyze the space leases or business operation, as the case may be, to determine whether they will provide sufficient cash flow to pay the ground lease rent payments and any additional costs which the ground lessee is required to cover pursuant to the ground lease terms (e.g. taxes, utilities, maintenance, insurance).

d. If the SSG, in conjunction with its third-party modeling vendor, and in its sole discretion and analytical judgment, determines that it is unable to model the space leases or business operation, as the case may be, and if the transaction has been assigned a public or private Eligible NAIC CRP Rating the SVO shall proceed with an analysis of the transaction guided by the available analyses of all NAIC CRPs that provided an Eligible NAIC CRP Rating on the transaction. For the avoidance of doubt, the SVO’s analysis will be entirely at the discretion of the SVO and the SVO is not obligated to accept or follow the rating methodology of any NAIC CRP and can, in its sole discretion and based on its analytical judgement, assign an NAIC Designation which differs from the correlated Eligible NAIC CRP Rating or choose not to assign any NAIC Designation. The SVO may, in its sole discretion, upon written request from the submitting investor, disclose its rationale as to why such transaction was not given a Designation correlated to the Eligible NAIC CRP Rating.

e. Should the SVO or, if applicable, SSG determine that it cannot assign an NAIC Designation to the GLF, the GLF would be ineligible for Schedule D reporting.

GLF Specific Considerations

313. The space lease payments or business operation, as the case may be, should be sufficient to cover any recurring costs the ground lessee is obligated to pay (e.g. taxes, utilities, maintenance, insurance) pursuant to the terms of the ground lease. All such ground lessee obligations will be factored into the SSG’s financial model of the space leases or business operations, if applicable.

314. To provide comfort that there will be no environmental liabilities, the filing documents shall include a Phase I environmental report showing no environmental problems and, if the Phase I report shows a
problem or the nature and prior used of the land indicates a substantial likelihood of preexisting environmental contamination, a Phase II environmental report.

315. Typically, a ground lease will require the ground lessee to hold the following insurance to protect the ground lease payments from potential shortfall due to the termination or abatement of space lease payments or reduction or termination of business operation upon the occurrence of condemnation or casualty or other insurable condition. Any of the insurable risks below that are not insured should be otherwise mitigated and evidence of such mitigant should be included in the filing documents.

a. Casualty insurance in an amount of coverage equal to 100% of the replacement value of the improvements with the fee lender named as the loss payee.
b. Rent loss insurance in an amount of coverage equal to at least 12 months of ground rent with the fee lender named as loss payee.
c. General liability insurance. The amount of coverage shall be sized appropriately, depending on the size and type of building (e.g. office, hotel, warehouse, intermodal facility, etc.).
d. Ground Lessor would be required to purchase special risk condemnation insurance in an amount of coverage equal to the principal amount of the GLF. This policy shall be prepaid and remain in place for the entire term of the GLF secured by the fee mortgage.

Note: All insurance must be issued by a carrier with an NAIC Designation equivalent rating of 1.G or better.

Part Four – The NAIC Structured Securities Group

Ground Lease Financing Transactions

Definition

36. Ground Lease Financing (GLF) transactions are defined and explained in “Ground Lease Financing Transactions” in Part Three of this Manual.

SSG Role and Process

37. On occasion the SVO may refer a GLF transaction to the SVO for financial modeling of the GLF space leases or business operation, as applicable, in accordance with the process set forth in “Ground Lease Financing Transactions” in Part Three of this Manual. Following an SVO referral the SSG and SVO will maintain open communication related to requests for additional data, analytical questions and analytical conclusions. Any GLF transaction NAIC Designation will be assigned by the SVO.
VIA EMAIL
November 22, 2019

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Mr. Stewart Guerin, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64016-2197


Dear Mr. Fry, Mr. Guerin and Members of the NAIC Valuation of Securities Task Force:

The undersigned – CGA Capital, Waterway Capital (fka Bostonia Global Securities), Mesirow Financial, and CTL Capital (collectively, the “Lease-Backed Securities Industry Group”) – are writing you to comment on the above-referenced GLF Proposal.

As noted previously, the members of the Lease-Backed Securities Industry Group have multiple decades of experience in structuring and closing CTL transactions with over 100 separate institutional investors which have participated in over $25 billion of transactions which adhere to the guidelines set forth in the P&P Manual. Over the past 25 years, principals of our firms have worked closely with the NAIC SVO to devise and clarify the CTL guidelines, as well as on related efforts including matters governed by SSAP 26 and SSAP 43R. We believe our firms in the aggregate account for the vast majority of all CTL transactions held by institutional investors in the United States.

We have worked closely and collaboratively with the Valuation of Securities (E) Task Force and the NAIC Securities Valuation Office in connection with the ongoing effort to consider potential modifications to the P&P Manual with respect to rated ground lease-backed securities and CTL transactions generally, and we fully support the adoption of GLF Proposal exposed on October 31, 2019 and the amendment to the P&P Manual contemplated by the GLF Proposal as summarized in the NAIC SVO’s memorandum dated October 17, 2019. Without question, appropriate regulatory oversight and clear guidelines are essential to ensuring a well-functioning market and protecting the interests of regulated insurers and their policyholders. Hence, we applaud any effort which accomplishes those objectives while also supporting the flow of capital to mission-critical infrastructure, corporate, governmental, healthcare and not-for-profit commercial real estate projects throughout the United States.

We greatly appreciate this opportunity to provide comments to the SVO and the Task Force with respect to the GLF Proposal, and we very much look forward to continuing to work with the SVO and the Task Force to clarify matters related to CTLs generally, and to devise criteria necessary to secure Schedule D eligibility for other types of well-structured credit-supported, commercial mortgage-backed or lease-backed securities that are not currently expressly contemplated by the P&P Manual.

Sincerely,

W. Kyle Gore
Managing Director & Principal
CGA Capital, LLC (on behalf of the Lease-Backed Securities Industry Group)

cc: Charles Therriault, National Association of Insurance Commissioners
    Tessa Maier, National Association of Insurance Commissioners
    Thomas A. Sargent, Waterway Capital LLC
    Nat Sager, Mesirow Financial
    Thomas Zarrilli, CTL Capital
MEMORANDUM

TO: Kevin Fry, 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)

CC: Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)
    Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Proposed Amendment to the *Purpose and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Remove the Financial Modeling Instructions for RMBS/CMBS Securities and Direct IAO Staff to Produce NAIC Designation and NAIC Designations Categories for these Securities

DATE: September 30, 2019

1. **Summary** – On Oct. 11, 2018, the Valuation of Securities (E) Task Force adopted an amendment to delete the Modified Filing Exempt (MFE) provisions from the P&P Manual and directed a referral to the Statutory Accounting Principles (E) Working Group recommending the deletion of the MFE provisions from Statement of Statutory Accounting Principles (SSAP) No. 43R—Loan-Backed and Structured Securities. The effect of these changes resulted in these securities coming under the filing exempt instructions in the P&P Manual, if they have an Eligible NAIC CRP Credit Rating assigned to them. This change eliminated using the book adjusted carrying value to determine the NAIC designation for these securities.

The IAO staff reported to the Task Force at the Summer National Meeting that at some point the NAIC should align the RMBS/CMBS modeling to provide a single NAIC Designation for modeled RMBS/CMBS. This would be a change from the current practice of providing a series of book adjusted carrying value price breakpoints to companies to determine the NAIC designation. Staff also reported that with the upcoming implementation of NAIC designation categories, the new 20 additional granular delineations of credit risk, the complexity and expense to the NAIC and insurers to produce and incorporate the needed 19 price breakpoints would be high.

2. **Recommendation** – The IAO staff recommends that the NAIC move to a single NAIC designation and NAIC designation category modelled assessment of credit risk for RMBS/CMBS. This is a good time to make such a change prior to the NAIC and insurance companies making modifications to their systems for the NAIC designation categories. Such a change will produce a uniform and consistent credit risk assessment for these securities permitting insurers to report the same SSG determined NAIC designation. Given the impact of this change to SSAP 43R - Loan-Backed and Structured Securities, staff recommends a referral to the Statutory Accounting Principles (E) Working Group for a simultaneous exposure.

3. **Proposed Amendment** – The following text shows the revisions in Part Four that would appear in the 2019 P&P Manual format.
PART FOUR
THE NAIC STRUCTURED SECURITIES GROUP
DEFINITIONS

1. The following terms used in this Part Four have the meaning ascribed to them below.

- **ABS** stands for asset-backed securities and means structured securities backed by consumer obligations originated in the United States.

- **CMBS** stands for commercial mortgage-backed securities and means structured securities backed by commercial real estate mortgage loans originated in the United States. The definition of CMBS may refer to securitizations backed by commercial mortgages, respectively, originated outside of the United States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: (a) has the necessary information about the commercial mortgage and commercial mortgage loans originated outside of the United States to fully model the resulting securities; and (b) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.

- **Initial Information** means the documentation required to be filed with an Initial Filing of an RMBS or a CMBS CUSIP, pursuant to the section below and pertaining to Loan Information, Reps and Warranty Information and Structure and Formation Information for the transaction, where:
  
  - **Loan Information** means a review of the loan files by a third party to assess the sufficiency of legal title and other related issues.
  
  - **Reps and Warranty Information** means the actual representation and warranties in effect for the securitization given by the mortgage originator(s) to the Trust pertaining to loan origination processes and standards, compliance with applicable law, loan documentation and the process governing put backs of defective mortgages back to the originator(s).
  
  - **Structure and Formation Information** means the waterfall, as described in the definition of Ongoing Information, information and documentation in the form of legal opinions and documentation governing the formation of the securitization and its entities relative to issues such as bankruptcy remoteness, true sale characterization, the legal standards and procedures governing the securitization and other similar issues.

- **Legacy Security**, for the purposes of this section shall mean any RMBS and any CMBS that closed prior to January 1, 2013.
- Official Price Grids means and refers to those generated by the SSG and provided to an insurance company or insurance companies that own the security for regulatory reporting purposes.

- Ongoing Information consists of: (a) tranche level data; such as principal balance, factors, principal and interest due and paid, interest shortfalls, allocated realized losses, appraisal reductions and other similar information for the specific tranche; (b) trust level data, such as aggregate interest and principal and other payments received, balances and payments to non-tranche accounts, aggregate pool performance data and other similar information; (c) loan level performance information; and (d) a computerized model of rules that govern the order and priority of the distribution of cash from the collateral pool (i.e., the “waterfall”) to the holders of the certificates/securities—provided in the format and modeling package used by the NAIC financial modeling vendor.

- Original Source, with respect to a specific set of data, means the Trustee, Servicer or similar entity that is contractually obligated under the agreement governing the RMBS or CMBS to generate and maintain the relevant data and information in accordance with standards specified in applicable agreements or an authorized re-distributor of the same.

- Price Grids means and refers to CUSIP-specific price matrices containing six price breakpoints; i.e., each price corresponding to a specific NAIC Designation category. Each breakpoint on a Price Grid is the price point that tips the NAIC Designation for the RMBS CUSIP into the next NAIC Designation (credit quality/credit risk) category. The plural is used because two Price Grids are generated for any CUSIP. This reflects the difference in RBC for those insurance companies that maintain an asset valuation reserve and for those insurance companies that do not.

- Re-REMIC is a securitization backed by: (a) otherwise eligible RMBS from one or two transactions; or (b) otherwise eligible CMBS from one or two transactions at closing. Re-REMICs cannot acquire any Underlying Securities after closing.
- **RMBS** stands for residential mortgage-backed securities and means structured securities backed by non-agency residential mortgages originated in the United States, where the collateral consists of loans pertaining to non-multi-family homes. That includes prime, subprime and Alt-A mortgages, as well as home-equity loans, home-equity lines of credit and Re-REMICs of the above. Excluded from this definition is agency RMBS, where the mortgages are guaranteed by federal and federally sponsored agencies such as the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC) and loans against manufactured or mobile homes or collateralized debt obligations backed by RMBS. The exclusion covers bonds issued and guaranteed by, or only guaranteed by, the respective agency. Also not included are loans guaranteed by the U.S. Department of Veteran Affairs or the U.S. Department of Agriculture’s Rural Development Housing and Community Facilities Programs. The definition of RMBS may refer to securitizations backed by residential mortgages, respectively, originated outside of the United States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: (a) has the necessary information about the residential mortgage and residential mortgage loans originated outside of the United States to fully model the resulting securities; and (b) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.

- **Underlying Security** means the RMBS or CMBS backing a Re-REMIC. A Re-REMIC cannot be an Underlying Security.

**NOTE:** The definitions of RMBS and CMBS reflect limitations associated with the financial modeling process, NAIC credit rating provider (CRP) internal naming conventions and SSG processes, as more fully discussed below and may, therefore, be subject to a narrower or a broader reading in any reporting period. Please call the SSG with any concerns or questions about the scope of the definitions for a given reporting period. Also note:

- It is possible that the scope of the RMBS and CMBS definitions may be broadened because the financial modeling vendors indicate other collateral or waterfall structures can be modeled.
- NAIC CRPs may adopt different internal conventions with respect to what market or asset segments are within their rated populations of RMBS, CMBS or ABS. This could affect the application of the adopted NAIC methodology or require the NAIC to select which naming process it wishes to adopt.

- It is possible that the SSG will acquire analytical assessment capabilities that permit the assessment of existing, additional or different structured securities that cannot now be modeled or that are not currently rated.
ADMINISTRATIVE AND OPERATIONAL MATTERS

Certain Administrative Symbols

2. The following SVO administrative symbols are used in the Valuation of Securities (VOS) Products to identify RMBS and CMBS that the NAIC vendor has confirmed will be subject to the financial modeling methodology described in this Part.

- **FMR** – Indicates that the specific CUSIP identifies an RMBS that is subject to the financial modeling methodology.

- **FMC** – Indicates that the specific CUSIP identifies a CMBS that is subject to the financial modeling methodology.

The use of these SVO administrative symbols in the VOS Product and published in the AVS+ Products compiled by the SVO and SSG as the SVO List of Investment Securities means the insurer should not use the filing exempt process for the security so identified.

**NOTE:** The administrative symbols **FMR** and **FMC** are related to symbols that insurers are required to use in the financial statement reporting process. Under applicable financial statement reporting rules, an insurer uses the symbol **FM** as a suffix to identify modeled RMBS and CMBS CUSIPs. The symbol **FM** is inserted by the insurer in the financial statement as a suffix in front of the NAIC Designation category; i.e., **2FM**.

Quarterly Reporting of RMBS and CMBS

3. To determine the NAIC Designation to be used for quarterly financial statement reporting for an RMBS or CMBS purchased subsequent to the annual surveillance described in this Part, the insurer uses the prior year-end assigned NAIC Designation and NAIC Designation Category modeling data for that CUSIP (which can be obtained from the NAIC) and follows the instructions in contained under the heading “Use of Net Present Value and Carrying Value for Financially Modelled RMBS and CMBS” below or follows the instructions in “Publication of Final Results” below, subject to, and in accordance with, SSAP No. 43R—Loan-Backed and Structured Securities.
Limited Filing Exemption for RMBS and CMBS

4. **RMBS and CMBS that can be Financially Modeled** – RMBS and CMBS that can be financially modeled are exempt from filing with the SVO. NAIC Designations and NAIC Designation Categories for RMBS and CMBS that can be financially modeled are assigned by SSG determined by application of the methodology discussed in this Part, not by the use of credit ratings of CRPs.

5. **RMBS and CMBS securities that cannot be Financially Modeled**
   - **But Are Rated by a CRP** – RMBS and CMBS that cannot be financially modeled but that are rated by a CRP are exempt from filing with the SSG. The NAIC Designations and NAIC Designation Categories for these RMBS and CMBS are determined by application of the filing exemption procedures discussed in this Manual.
   - **But Are Not Rated by a CRP** – RMBS and CMBS that cannot be financially modeled and that are not rated by a CRP are not filing exempt and must be filed with the SSG or follow the procedures, as discussed below in this Part.

Filing Exemption for ABS

6. ABS rated by a CRP are exempt from filing with the SSG.

Review of Decisions of the SSG

7. Analytical decisions made through the application of financial modeling are not subject to the appeal process. In the absence of an appeal, the SSG shall provide whatever clarification as to the results of financial modeling is possible to any insurer who requests it and owns the security, provided that it is not unduly burdensome for the SSG to do so. Any decision made by the SSG that results in the assignment of an NAIC Designation (including NAIC Designation Categories) and does not involve financial modeling methodology, whether developed by the SSG on its own or in collaboration with the SVO, is subject to the appeal process.
REQUIRED DATA AND DOCUMENTS FOR TRANSACTIONS SUBMITTED TO THE SSG

8. The policy statement set forth in this section shall be applicable generally to any transaction filed with the SSG for an analytical assessment and, including, but not limited to, a Price Grid or for assignment of an NAIC Designations and NAIC Designation Categories. Any filing with the SSG is deemed to be incomplete unless the insurer has provided the information, documentation, and data in quantity and quality sufficient to permit the SSG to conduct an analysis of the creditworthiness of the issuer and the terms of the security to determine the requested analytical value. It is the obligation of the reporting insurance company to provide the SSG with all necessary information. It is the responsibility of the SSG to determine whether the information provided is sufficient and reliable for its purposes and to communicate informational deficiencies to the reporting insurance company.

Documentation Standards

9. In order for an insurer-owned RMBS or CMBS to be eligible for the year-end modeling process, conducted pursuant to this section below, the analysis must be based on information, documentation and data of the utmost integrity. A Legacy Security must meet the Ongoing Information requirements. An RMBS, CMBS or Re-REMIC that is not a Legacy Security must meet the Initial Information and Ongoing Information requirements. For the purposes of determining a Re-REMIC’s status as a Legacy Security, the closing date of the Re-REMIC (not the Underlying Security) shall be used. The SSG may, in its sole discretion, determine that the Initial Information and/or Ongoing Information is not sufficient and/or not reliable to permit the RMBS or CMBS CUSIP to be eligible for financial modeling. If the SSG determines that the Initial Information and/or Ongoing Information is not sufficient and/or not reliable to permit the RMBS or CMBS CUSIP to be eligible for financial modeling, it will communicate this decision to the insurer and invite a dialogue to ascertain whether alternative information is available that would be deemed sufficient and/or reliable by the SSG.

Initial Information Requirements

10. An RMBS or CMBS meets the Initial Information Requirements if the security meets one of the following three conditions:

- **RTAS** – The RMBS or CMBS was assigned a preliminary price grid or designation as described in this Part;

- **Initial Sufficiency Filing** – The RMBS or CMBS was reviewed by SSG through an Initial Sufficiency Filing; or
- **Safe Harbor** – The RMBS or CMBS meets the Safe Harbor requirements.

**Initial Sufficiency Information Filing**

11. An insurance company may file Initial Sufficiency Information with the SSG for the purpose of obtaining a determination that an RMBS or CMBS CUSIP is eligible for financial modeling under the annual surveillance process discussed below. Initial Sufficiency Information is only filed once for any given RMBS or CMBS. Reporting insurance companies are solely responsible for providing the SSG with Initial Information. A determination by the SSG that a given RMBS or CMBS CUSIP is eligible for financial modeling after an Initial Sufficiency Filing assessment is subject to the further and continuing obligation that the SSG obtain or the insurer provide the SSG with updated Ongoing Information close to the date of the annual surveillance.

12. **Required Documents for Initial Sufficiency Filing** – An insurer that owns an RMBS or a CMBS for which Initial Information is not publicly available shall provide the SSG with the following documentation.

13. **RMBS** – Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for an RMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:
   - Pooling and Servicing Agreement or similar
   - Prospectus, Offering Memorandum or similar; Accountant’s comfort letter
   - If applicable, ISDA Schedules and Confirmations or similar
   - Legal opinions given in connection with the transaction
   - Any other documents referenced by the above
   - Third-Party Due diligence scope document and raw results. If less than 100% due diligence, detailed description of the loan selection process
   - If applicable, loan purchase agreements or similar. Loan Tape

14. **CMBS** – Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for a CMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:
   - Pooling and Servicing Agreement or similar
   - Prospectus, Offering Memorandum or similar; Accountant’s comfort letter
   - If applicable, ISDA Schedules and Confirmations or similar
Attachment Six
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12/8/2019

- Legal opinion given in connection with the transaction
- Any other documents referenced in the above
- Asset Summaries
- Loan Tape

Loan documents, including reliable information about the terms of the transaction; including, but not limited to, financial covenants, events of default, legal remedies and other information about financial, contractual or legal aspects of the transaction in form and substance consistent with industry best practices for CMBS issuance.

- In certain cases, additional documents below will enable the SSG to verify and validate initial underwriting information of the property securing the CMBS. These documents may be required in form and substance consistent with best practices for typical CMBS issuance.

- Historical operating statements and borrower’s budget
- Underwriter’s analysis of stabilized cash flow with footnotes of assumptions used
- Property type specific, rent roll information
- Appraisals and other data from recognized industry market sources
- Independent engineering report (Property Condition Assessment)
- Environmental Site Assessment (ESA) – Phase I/Phase II
- Documentation related to seismic, flood and windstorm risks
- Franchise agreements and ground leases, if applicable
- Management agreements

**SSG Modeling Alerts**

15. The SSG shall at all times have discretion to determine that differences in the structure, governing law, waterfall structure or any other aspect of a securitization or a class of securitization requires that insurance companies provide Initial Information and/or Ongoing Information additional to or different from that identified in this Part. The SSG shall communicate such additional or different documentation requirements to insurers by publishing a Modeling Alert on the NAIC website and scheduling a meeting of the VOS/TF to ensure public dissemination of the decision.
Safe Harbor

16. Safe Harbor options serve as proxies for the Initial Sufficiency filing. The options reflect publicly available information that a third party has analyzed the Initial Information. Because the structured securities market is quite dynamic, the list of Safe Harbor options may change frequently, with notice and opportunity for comment, as described in this section. An RMBS or CMBS meets the Initial Information requirement if:

- At least two Section 17(g)-7 reports issued by different CRPs are publicly available; or
- A security that is publicly registered under the federal Securities Act of 1933.

Ongoing Information Requirements

17. An RMBS or CMBS meets the Ongoing Information Requirements if Ongoing Information is available to the SSG and the relevant third-party vendor from an Original Source. The SSG, in its sole discretion and in consultation with the relevant third-party vendor, may determine that the Ongoing Information is not sufficient or reliable to permit a given RMBS or CMBS CUSIP to be financially modeled. However, in making such a determination, the SSG shall take into account reasonable market practices and standards.

Special Rules for Certain Re-REMICs

18. Re-REMICs are generally simple restructurings of RMBS or CMBS. An Initial Sufficiency Filing for a Re-REMIC (a) which is not a Legacy Security itself but (b) where each Underlying Security is a Legacy Security shall not require submission of information regarding the Underlying Securities. In most cases, a prospectus for the Re-REMIC will be sufficient. If the SSG determines that additional information about the Re-REMIC structure or formation is required, it will communicate this decision to the insurer and invite a dialogue to ascertain whether additional information is available that would be deemed sufficient by the SSG.
ANALYTICAL ASSIGNMENTS

Annual Surveillance of RMBS and CMBS – Modeled and Non-Modeled Securities

Scope

19. This section explains the financial modeling methodology applicable to RMBS and CMBS (defined above) securitizations  and the book/adjusted carrying value methodology applicable to modeled and non-modeled securities subject to SSAP No. 43R—Loan-Backed and Structured Securities. Please refer to SSAP No. 43R for a description of securities subject to its provisions. The VOS/TF does not formulate policy or administrative procedures for statutory accounting guidance. Reporting insurance companies are responsible for determining whether a security is subject to SSAP No. 43R and applying the appropriate guidance.

Important Limitation on the Definitions of RMBS and CMBS

20. The definitions of RMBS and CMBS above are intended solely to permit the SSG to communicate with financial modeling vendors, insurance company investors who own RMBS and CMBS subject to financial modeling and/or the book/adjusted carrying value methodology and their investment advisors to facilitate the performance by the SSG of the financial modeling methodology described below. The definitions contained in this section are not intended for use and should not be used as accounting or statutory statement reporting instructions or guidance.

NOTE: Please refer to SSAP No. 43R—Loan-Backed and Structured Securities for applicable accounting guidance and reporting instructions.

Analytical Procedures Applicable to RMBS and CMBS Securitizations Subject to Financial Modeling Methodology

Filing Exemption Status of RMBS and CMBS

21. RMBS and CMBS are not eligible for the filing exemption because credit ratings of CRPs are no longer used to set risk-based capital (RBC) for RMBS or CMBS. However, RMBS and CMBS are not submitted to the SSG.
Use of Financial Modeling for Year-End Reporting for RMBS and CMBS

22. Beginning with year-end 2009 for RMBS and 2010 for CMBS, NAIC Designations and NAIC Designation Categories probability weighted net present values will be assigned by SSG produced under NAIC staff supervision by an utilizing the NAIC-selected vendor’s using its financial model output with defined analytical inputs selected by the SSG. The vendor will provide the SSG with a range of net present values with a risk profile for each RMBS or CMBS sufficient for SSG to assess the credit risk of these securities and assign an NAIC Designation and NAIC Designation Category, corresponding to each NAIC Designation category. The NAIC Designation for a specific RMBS or CMBS is determined by the insurance company, based on book/adjusted carrying value ranges.

NOTE: Please refer to SSAP No. 43R—Loan-Backed and Structured Securities for guidance on all accounting and related reporting issues.

Analytical Procedures for RMBS and CMBS

23. The SSG shall develop and implement all necessary processes to coordinate the engagement by the NAIC of a vendor who will perform loan-level analysis of insurer-owned RMBS and CMBS using the vendor’s proprietary models.

RMBS and CMBS Subject to Financial Modeling

Setting Microeconomic Assumptions and Stress Scenarios

24. Not later than September of each year, the SSG shall begin working with the vendor to identify the assumptions, stress scenarios and probabilities (hereafter model criteria) the SSG intends to use at year-end to run the vendor’s financial model.

The Financial Modeling Process

25. Information about the financial modeling process can be found at www.naic.org/structured_securities/index_structured_securities.htm.
Cashflow and Expected Losses: Use of Net Present Value and Carrying Value for Financially Modeled RMBS and CMBS

26. For each modeled RMBS and CMBS, the financial model determines the net present value in a number of macro-economic scenarios, at which the expected loss equals the midpoint between the RBC charges for each NAIC Designation; i.e., each price point, if exceeded, changes the NAIC Designation. Net present value is the net present value of principal losses, discounted using the security’s coupon rate (adjusted in case of original issue discount securities to book yield at original issue and in case of floating rate securities, discounted using LIBOR curve + Origination spread). Because of the difference in RBC charge, the deliverable is five values for each RMBS and CMBS security for companies required to maintain an asset valuation reserve (AVR) and five values for companies not required to maintain an AVR. This is illustrated in the chart below. SSG then maps the weighted net present value to NAIC Designations and NAIC Designation Categories.

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27. The NAIC Designation for a given modeled RMBS or CMBS CUSIP owned by a given insurance company depends on the insurer’s book/adjusted carrying value of each RMBS or CMBS, whether that carrying value, in accordance with SSAP No. 43R—Loan-Backed and Structured Securities, paragraphs 25 through 26a, is the amortized cost or fair value, and where the book/adjusted carrying value matches the price ranges provided in the model output for each NAIC Designation; except that an RMBS or CMBS tranche that has no expected loss under any of the selected modeling scenarios and that would be equivalent to an NAIC 1 Designation if the filing exempt process were used, would be assigned an NAIC 1 Designation regardless of the insurer’s book/adjusted carrying value.

NOTE: Please refer to the detailed instructions provided in SSAP No. 43R.

Securities Not Modeled by the SSG and Not Rated by an NAIC CRP or Designated by the SVO

28-27. Securities subject to SSAP No. 43R—Loan-Backed and Structured Securities that cannot be modeled by the SSG and are not rated by an NAIC CRP or designated by the SVO are either: (a) assigned the NAIC administrative symbol ND (not designated), requiring subsequent filing with the SVO; or (b) assigned the NAIC Designation for Special Reporting Instruction [i.e., an NAIC 5GI or NAIC 6* (six-star)].
MORTGAGE REFERENCED SECURITIES

Definition

29.28. A Mortgage Referenced Security is a category of a Structured Note, as defined in Part Three of this Manual. In addition to the Structured Note definition, the following are characteristics of a Mortgage Referenced Security: A Mortgage Referenced Security’s coupon and/or principal payments are linked, in whole or in part, to prices of, or payment streams from, real estate, index or indices related to real estate, or assets deriving their value from instruments related to real estate, including, but not limited to, mortgage loans.

Quarterly Reporting for Mortgage Reference Securities (pending adoption)

30.29. To determine the NAIC Designation to be used for quarterly financial statement reporting for a Mortgage Reference Security purchased subsequent to the annual surveillance described in this Part, the insurer uses the prior year-end modeling data for that CUSIP (which can be obtained from the NAIC) until the annual surveillance data is published for the current year. For a Mortgage Reference Security that is not in the prior year-end modeling data for that CUSIP, the insurer may follow the instructions in Part Two of this manual for the assignment of the SVO Administrative Symbol “Z” provided the insurer owned security meets the criteria for a security that is in transition in reporting or filing status.

Not Filing Exempt

34.30. A Mortgage Referenced Security is not eligible for the filing exemption but is subject to the filing requirement.

NAIC Risk Assessment

32.31. In determining the NAIC Designation of a Mortgage Referenced Security, the SSG may use the financial modeling methodology discussed in this Part, adjusted to the specific reporting and accounting requirements applicable to Mortgage Referenced Securities.
THE RTAS – EMERGING INVESTMENT VEHICLE

Purpose

33. Price grids are generated for the exclusive use of insurance companies and the NAIC regulatory community. Insurance companies use official Prices Grids by following the instructions in SSAP No. 43R — Loan-Backed and Structured Securities to derive a final NAIC Designation for the RMBS or CMBS, which they use to derive the RBC applicable for the RMBS or CMBS.

NOTE: Please refer to SSAP No. 43R for a full explanation of the applicable procedure.

Extension of Authority

34.32. The Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure is extended to the SSG, and the SSG is authorized to determine probable regulatory treatment for RMBS and CMBS pursuant to this Part or for other securities, where, in the opinion of the SSG, financial modeling methodology would yield the necessary analytical insight to determine probable regulatory treatment or otherwise enable the SSG to make recommendations to the VOS/TF as to regulatory treatment for a security.

Interpretation

35.33. To facilitate this purpose, wherever in the Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure reference is made to the SVO, it shall be read to also refer to and apply to the SSG, adjusting for differences in the operational or methodological context. The Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure shall also be read as authority for collaboration between SVO and SSG staff functions so as to encompass RTAS assignments that require the use of SVO financial, corporate, municipal, legal, and structural analysis and related methodologies, as well as of financial modeling methodologies.
Translation of Preliminary into Official Price Grids

36.—— Price Grids generated by the SSG pursuant to an RTAS are preliminary within the meaning of that term as used in the Regulatory Treatment Assessment Service – Emerging Investment Vehicle procedure and accordingly cannot be used for official NAIC regulatory purposes. Preliminary NAIC Designations are translated into official NAIC Designations by the SVO when an insurance company purchases and files the security and the SVO conducts an official assessment. However, this Manual does not require the filing of RMBS and CMBS subject to financial modeling methodology with the SSG. It is, therefore, necessary to specify a procedure for the translation of preliminary Price Grids into official Price Grids that can be used for NAIC regulatory purposes. Preliminary Price Grids generated by the SSG become an official Price Grid within the meaning of this section when an insurance company has purchased the security for which the Price Grid was generated and reported that security for quarterly reporting purposes using the SSG generated Price Grid. A Price Grid for a security reported by an insurance company for quarterly reporting is effective until the SSG conducts the next annual surveillance pursuant to this Part at which time the Price Grids generated by the SSG at year-end shall be the official Price Grid for that security.