



NATIONAL MEETING FALL 2022

Draft date: 11/28/2022

*2022 Fall National Meeting
Tampa, Florida*

Valuation of Securities (E) Task Force

Wednesday, December 14, 2022

2:00 p.m. – 3:30 p.m. ET

HB Plant Ballroom E & F – Level 2 – JW Marriot

ROLL CALL

Member	Representative	State
Doug Ommen, Chair	Carrie Mears	Iowa
Scott A. White, Vice Chair	Doug Stolte	Virginia
Lori K. Wing-Heier		Alaska
Evan G. Daniels	David Lee	Arizona
Ricardo Lara	Laura Clements	California
Andrew N. Mais	Kathy Belfi	Connecticut
Trinidad Navarro	Rylynn Brown	Delaware
David Altmaier	Carolyn Morgan	Florida
Dean L. Cameron	Eric Fletcher	Idaho
Dana Popish Severinghaus	Vincent Tsang	Illinois
Vicki Schmidt	Tish Becker	Kansas
James J. Donelon	Stewart Guerin	Louisiana
Kathleen A. Birrane	Matt Kozak	Maryland
Gary D. Anderson	John Turchi	Massachusetts
Chloria Lindley-Myers	Debbie Doggett	Missouri
Eric Dunning	Lindsay Crawford	Nebraska
Marlene Caride	Nakia Reid	New Jersey
Adrienne A. Harris	James Everett	New York
Cassie Brown	Amy Garcia	Texas
Jon Pike	Jake Garn	Utah
Mike Kreidler	Tim Hays	Washington

NAIC Support Staff: Charles Therriault/Marc Perlman

AGENDA

Consider for Adoption:

1. Consider Adoption of the October 20 and Summer National Meeting Minutes Attachment One
(Doc. ID: 2022.013-01, 2022.014-01) Attachment Two
—Carrie Mears (IA), Charles Therriault (NAIC), Marc Perlman (NAIC)

Discuss Comments and Consider for Adoption or Re-Exposure:

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| 2. Proposed P&P Manual Amendment to Include Collateralized Loan Obligations (CLO) as a Financially Model Security in Part Four
(Doc. ID: 2022.004-12, 2022.004-13)
—Carrie Mears (IA), Eric Kolchinsky (NAIC), Charles A. Therriault (NAIC), Marc Perlman (NAIC) | Attachment Three
Attachment Three - A |
| 3. Proposed P&P Manual Amendment to Update Instructions for Related Party and Subsidiary, Controlled and Affiliated Investments
(Doc. ID: 2022.008-04, 2022.008.05, 2022.008.06)
—Carrie Mears (IA), Charles A. Therriault (NAIC), Marc Perlman (NAIC) | Attachment Four
Attachment Four A - B |
| 4. Proposed P&P Manual Amendment to Clarify the Definition of an NAIC Designation in Part One and Part Two
(Doc. ID: 2022.012-01, 2022.012.02, 2022.012.03, 2022.012.04)
—Carrie Mears (IA), Charles A. Therriault (NAIC), Marc Perlman (NAIC) | Attachment Five
Attachment Five A - C |

Discuss and Consider for Exposure or Referral:

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| 5. Proposed P&P Manual Amendment to Add Instructions for Structured Equity and Funds
(Doc. ID: 2022.015-01)
—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC) | Attachment Six |
| 6. Proposed P&P Manual Amendment to Update References to SGI
(Doc. ID: 2022.016-01)
—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC) | Attachment Seven |
| 7. Proposed CLO Modeling Methodology (Excluding Scenarios and Probabilities)
(Doc. ID: 2022.017-01)
—Carrie Mears (IA), Eric Kolchinsky (NAIC), Charles A. Therriault (NAIC), and Marc Perlman (NAIC) | Attachment Eight |

Hear or Receive Staff Reports:

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| 8. Receive a Report on the Projects of the Statutory Accounting Principles (E) Working Group
—Carrie Mears (IA) and Julie Gann (NAIC) | |
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9. Discuss Any Other Matters Brought Before the Task Force

10. Adjournment

Draft: 11/2/22

Valuation of Securities (E) Task Force
Virtual Meeting
October 20, 2022

The Valuation of Securities (E) Task Force met Oct. 20, 2022. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Scott A. White, Vice Chair, represented by Doug Stolte (VA); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone and Kathryn Belfi (CT); Dean L. Cameron represented by Eric Fletcher (ID); Dana Popish Severinghaus represented by Vincent Tsang (IL); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Eric Dunning represented by Lindsay Crawford (NE); Marlene Caride represented by John Sirovetz (NJ); Adrienne A. Harris represented by Jim Everett (NY); Cassie Brown represented by Amy Garcia (TX); Jon Pike represented by Jake Garn (UT); and Mike Kreidler represented by John Jacobson (WA).

1. Adopted its 2023 Proposed Charges

Mears said the first item is to consider adoption of the Task Force's 2023 proposed charges. Most of its 2023 proposed charges are unchanged from 2022. However, there are two additional charges for 2023, with some clean-up references to other groups. The new charges are as follows:

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

Charge J is a continuation of the existing charge "I," which says that the Task Force will: *"Implement policies to oversee the NAIC's staff administration of rating agency ratings used in NAIC processes, including staff's discretion over the applicability of their use in its administration of filing exemption."* This new charge would begin establishing what criteria is needed for when staff's discretion is permitted.

Charge K is consistent with the fixed income analytical risk measures the Task Force is considering. That effort is supported by the regulators of the Financial Stability (E) Task Force and Macroprudential (E) Working Group as mentioned in their referral to this Task Force dated July 21, 2022. Referrals will be sent to a number of NAIC groups requesting their feedback based on the last exposure from the Summer National Meeting.

Mears said that no comment letters were received on the Task Force's proposed charges.

Michael Murray (Paul Hastings LLP on behalf of Egan Jones Rating Company) said the proposed change in the charges, which empowers the NAIC to overrule and disregard ratings provided by private firms, would be a significant mistake. He said the Securities Valuation Office (SVO) is in a unique position. It is both a de facto regulator through updates to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) and a market participant by way of the issuance of designations, which act in a manner similar to ratings. This dual role of being both a regulator and a market participant gives rise to numerous complex issues and provides both the opportunity and the motivation to steer business to itself.

Murray said this is not an idle concern, as the SVO has effectively monopolized ratings or designations in the following areas: principle protected securities (PPS), exchange-traded funds (ETFs), credit tenant loans (CTLs), and ground lease financing (GLF) transactions, until that was partially reversed. He said the change in the charges is the latest in a series of actions that are contrary to the will of the U.S. Congress, which sought to encourage “additional competition” in the ratings arena. He said that although the SVO claims its assessments are different from those of private firms, that is a feature, not a bug of the congressionally ordained regime, which is designed to foster diversity and competition in the space and indeed even forbids regulators from “regulating the substance of credit ratings or the procedures of methodologies by which any private firm determines credit ratings.”

Murray said there is little evidence that SVO assessments are superior to those of private firms. Unlike private firms, the SVO has no public methodologies, no separation of the analytics from the business side, no mandatory review of models and methodologies, no review of policies and procedures by a party such as the U.S. Securities and Exchange Commission (SEC), and no deep wellspring of expertise. The notion that the SVO’s ratings are superior because they are lower also is flawed. The goal is timely, accurate ratings, not to depress ratings, which have the effect of depriving insurance company investors of attractive returns for policyholders. Just a few months ago, a large firm in the ratings space proposed to adopt a methodology that would have steered issuers and investors to the uses of its ratings. They appear to have abandoned that proposal in the face of comments from various bodies, including the U.S. Department of Justice (DOJ), stating that the proposal could raise significant concerns under the antitrust laws. The charges here and related actions raise an analogous conflict of interest. Murray said that he would be happy to address the nuanced specifics of the antitrust issues. He said the main message is that the changes in the charges are not appropriate, and he urged the deferral of any action on the charges.

Mears said these charges are not changing anything at this point. Any allowances for what the SVO staff will do with the charges is to establish any sort of criteria for when that discretion would be used. As that criteria goes through the normal due process, Mears said the Task Force welcomes Murray and the group he is representing to comment under the formal comment process, when it is exposed, and continue to have this conversation.

Charles A. Therriault (NAIC) said that this is an open process and that the Task Force welcomes feedback from all interested parties.

Stolte made a motion, seconded by Crawford, to adopt the Task Force’s 2023 proposed charges (Attachment). The motion passed unanimously.

2. Discussed and Exposed a Proposed P&P Manual Amendment to Include CLOs as a Financially Modeled Security in Part Four

Mears said the next item is to discuss comments and consider for exposure a proposed amendment to the P&P Manual to add reporting instructions for the financial modeling of collateralized loan obligations (CLOs).

Eric Kolchinsky (NAIC) said this proposal seeks to be the first step in allowing the Structured Securities Group (SSG) to go through the process of modeling CLOs. This step is necessary to begin planning the budgetary items. As discussed, this will be followed by a release and exposure of a methodology, which is the pipelines, as well as the scenarios, which will probably be the most controversial or, at least, a more deliberative step in the process. He said this allows the SSG to kick the process off and, to the extent some of this needs to be amended later, open to those changes to make sure everything fits the process that has been discussed and deliberated. At this point, the SSG is only looking to model the broadly syndicated loans CLOs. The intention is to eventually model the middle market CLOs, but they will be out of scope, at least in the first round of this implementation.

Mears said this is the first step in the process and somewhat procedural for budgetary reasons. She said there may need to be amendments later as the deliberations around the methodology and scenarios occur. An informational referral will be prepared for the Risk-Based Capital Investment Risk and Evaluation (E) Working Group to continue the coordination with that Working Group and to continue discussions on the risk-based capital (RBC) components. One comment letter was received from the American Council of Life Insurers (ACLI) on the exposure of the Capital Markets Bureau (CMB) CLO stress test methodology, year-end 2020 CLO stress test results, and SSG staff responses to previously received comment letters on a topic.

Mike Monahan (ACLI) said there was nothing further to add as this was an exposure.

Mears directed staff to expose the proposed P&P Manual amendment to include CLOs as a financially modeled security in Part Four for a 45-day comment period ending Dec. 5 and directed staff to refer the amendment to the Risk-Based Capital Investment Risk and Evaluation (E) Working Group.

3. Discussed Comments and Exposed a Proposed Amendment to the P&P Manual to Update Instructions for Related Party and SCA Investments

Mears said the next item is to receive, discuss, and consider for exposure a proposed amendment to the P&P Manual to update instructions for related party and subsidiary, controlled, and affiliated (SCA) investments.

Marc Perlman (NAIC) said this agenda item stems from a referral from the Statutory Accounting Principles (E) Working Group. On June 10 the Working Group sent a referral to the Task Force resulting from the Working Group's May 24 adoption of agenda item 2021-21: Related Party Report, which revised both *Statement of Statutory Accounting Principles (SSAP) No. 25—Affiliates and Other Related Parties* and *SSAP No. 43R—Loan-Backed and Structured Securities*, which raised comments about eligibility for FE for various affiliated structures.

The amendment required new reporting information for investments that involve a related party as sponsor, originator, manager, or other similar transaction party, regardless of whether the investment is captured on the affiliate reporting line.

The Working Group referred this matter to the Task Force, stating "The SVO may need to develop additional procedures to add a methodology to designate this type of asset-backed security investment structure, or to clarify that affiliated investments that do not have underlying affiliated credit exposure [meaning the affiliate exposure is to the special purpose entity (SPE) issuer, originator, sponsor or servicer rather than the underlying obligor] qualify for FE."

The Subsidiary, Controlled and Affiliated (SCA) Debt or Preferred Stock Investments section of the P&P Manual currently only requires insurers to file with the SVO bonds or preferred stock issued by an SCA entity. Therefore, a transaction with an affiliate or related party originator, sponsor, manager, or underlying obligor (credit exposure), as opposed to issuer, would not constitute an SCA investment as currently defined.

The SVO proposes amending the SCA section of the P&P to clarify that investments with related or affiliated SPE issuers or originators, sponsors, managers, or other similar parties of structured transactions will qualify for FE, unless a regulator refers it to the SVO for review, in which case it will be removed from FE. However, investments with related or affiliated underlying credit exposure (such as the obligors) could be ineligible for FE, even though the issuer is not affiliated or related.

First, structured transactions with affiliate or related parties that are not credit exposures (such as issuer SPEs, originators, sponsors, etc.) could, as stated in SSAP No. 25, be "subject to abuse because reporting entities may

be induced to enter transactions that may not reflect economic reality or may not be fair and reasonable to the reporting entity or its policyholders.” For example, an affiliated or related entity could originate several loans to unaffiliated and unrelated obligors and, for various reasons, sell those loans to an SPE, which could then issue a note to the reporting insurance company. The fact that the reporting insurance company is assuming the risk of the loans originated by an affiliate or related party could pose risks of abuse or unfairness even though neither the issuer nor the underlying loan obligors (the credit exposure) are affiliates or related parties. Transactions like this in which an affiliate or related party is not the issuer (typically a securitization or other structured finance transaction) are currently eligible for FE, and this amendment does not propose changing that. Such investments, however, would likely be in scope of SSAP No. 25 and subject to reporting as an affiliate or related party transaction in the appropriate investment schedules. State insurance regulators could, based upon the reporting of an affiliate or related party relationship, require that the reporting insurance company file an investment with the SVO for analysis and/or assignment of an NAIC designation, thereby removing it from the FE process.

A similar risk of possible abuse or unfairness exists if the underlying credit exposure has a relationship to the reporting insurance company, even if the issuer does not. Since, currently, only the relationship with the issuer determines whether the investment is ineligible for FE, the amendment proposes amending the SCA section of the P&P Manual so that certain investments with affiliated or related underlying credit exposure would also not be eligible for FE. The risk of abuse due to an affiliate or related underlying credit exposure could be minimal if the affiliate or related party obligors only constitute a small portion of the total underlying credit exposure, or very pronounced if they constitute a large portion. Therefore, the SVO recommends that only those investments that would qualify as a related party pursuant to paragraph 4.a. in SSAP No. 43R, due to affiliated or related party underlying credit exposure, be ineligible for FE.

While the SCA section of the P&P Manual is being reviewed for revisions, the SVO proposes clarifying that SCA investments, according to the P&P Manual, have always referred not only to affiliate transactions in which there is direct or indirect control between the reporting insurance company and a transaction entity, but also it refers to related parties where relationships other than control, as listed in SSAP No. 25, might exist. For example, the SVO reviewed a transaction in which there was no direct or indirect control between the reporting entity and the issuer, but there was a father/son relationship between the owner of the issuer and chief executive officer (CEO) of the reporting insurance company, a relationship that poses a risk of abuse, unfairness, or unreasonableness.

As such, the SVO proposes renaming the Subsidiary, Controlled and Affiliated (SCA) Debt or Preferred Stock Investments section of the P&P Manual to Subsidiary, Controlled and Affiliated (SCA) and Related Party Debt or Preferred Stock Investments to clarify that it includes non-control relationships, and amending SCA investment, SCA debt, and SCA preferred stock definitions to include related parties.

Lastly, to implement these changes, the SVO also proposes creating a new category of SCA and related party investment called SCA and Related Party Filing Exempt Investments, which would mean any investment (i) issued by an affiliate or related party SPE, which itself is not an obligor or ultimate source of the investment repayment, or (ii) issued as part of a structure in which the originator, sponsor, manager, servicer, or other influential transaction party is an affiliate or related party of the reporting insurance company. SCA and Related Party Filing Exempt Investments would be eligible for FE unless otherwise ineligible (for reasons other than their affiliate or related party status). The P&P Manual would also clarify that state insurance regulators are permitted, as specified in Part One of the P&P Manual, to require an insurance company to file what would otherwise be an SCA and Related Party Filing Exempt Investment for analysis and/or assignment of an NAIC designation only by the SVO, thereby making it ineligible for FE in the future.

Tsang asked what the SVO criteria is to determine whether a filed SCA and related party investment has term structure, complexity, and purpose like those transactions of unaffiliated parties. Is there a manual or standard

procedure for doing that? Mears said the Statutory Accounting Principles (E) Working Group, for year-end 2022, added a column to describe the nature of the affiliation for a particular investment, recognizing that any investment that has some sort of affiliate in nature should be reported on that affiliate investment line, but not all of them may have underlying credit exposure. There may be instances in which the asset manager would like the structure of the CLO that otherwise would be an affiliated credit exposure. There will be clarity into that as of year-end 2022. This is meant to provide clarification in those instances that would otherwise be an unaffiliated exposure, but the asset manager provided origination or structuring, and those transaction would still qualify for FE.

Tsang asked if the SVO already has criteria to make that determination and that companies should be able to follow it. Therriault said the SVO reviews the legal documents and the relationships that exist within those legal documents when it makes an assessment. It is not published criteria that insurers can follow. The related party example that Perlman gave would not have been something that would have been easily picked up on when there is a father-and-son relationship. The SVO analysts, through additional research, were able to make that connection. Some relationships are more transparent than others.

Tsang asked if a company has an investment being classified as an affiliated party and wants to make it unaffiliated, does the industry have any means of rectifying that. Mears said they should be following the SCA guidance that is defined by the Statutory Accounting Principles (E) Working Group, and that would be outside the purview of this group. That would be the responsibility of the insurer to make those identifications.

Therriault said the SVO are following the definition in the *Accounting Practices and Procedures Manual* (AP&P Manual) and is addressing the changes adopted to make sure that it is consistent with the AP&P manual. Mears said that would be a reporting question on how to apply the statutory guidance and probably a discussion for the Statutory Accounting Principles (E) Working Group.

Mears directed SVO staff to expose this proposed amendment to the P&P Manual to update instructions for related party and SCA investments for a 45-day public comment period ending Dec. 5.

4. Received, Discussed, and Exposed a Proposed Amendment to Clarify the Definition of an NAIC Designation in Part One and Part Two of the P&P Manual

Mears said the next agenda item is to receive, discuss, and consider exposure of a proposed amendment to clarify the definition of an NAIC designation in Part One and Part Two of the P&P Manual.

Therriault said NAIC designations are a specific risk measure created for NAIC regulatory purposes. They are not, and should never be, considered the functional equivalent of a rating from a rating agency, including nationally recognized statistical rating organizations (NRSROs) recognized and regulated by the U.S. SEC's Office of Credit Ratings (OCR). The purpose of NAIC designations, administered through the SVO, is to ensure that investments in securities made by state-regulated insurance companies satisfy objective and consistent standards for credit quality and, therefore, accurately reflect those companies' financial solvency as required by individual states. While some NAIC designations under the FE rule may be based upon a CRP rating mapped to a corresponding NAIC designation, the mere fact that a CRP rating could be converted to an NAIC designation does not, and never has, meant that the two are interchangeable. As noted in Part One of the P&P Manual, "The VOS/TF is resolved that the benefit obtained from the use [of] credit rating in state regulation of insurance must be balanced against the risk [of] blind reliance on credit ratings. To ensure the Task Force properly understands the composition and risk of the filing exempt securities population; promote uniformity in the production of NAIC Designations, reduce reporting exceptions for filing exempt securities and increase the efficiency of this NAIC process, the SVO and SSG

(hereafter, the IAO) is charged with administration of the filing exempt process defined in Part Three of this Manual.”

The updates being proposed to Part One and Part Two of the P&P Manual are intended to further clarify that NAIC designations are specifically intended to reflect their use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) that have been incorporated into state law by the states as participants in the Accreditation Program administered by the Financial Regulation Standards and Accreditation (F) Committee. It will also conform the definition of an NAIC designation in these two parts. The updated language will clarify three issues that are intrinsic to assessing investment risk for regulatory purposes and the use of NAIC designations:

- An NAIC designation reflects the likelihood of timely payment of principal and interest, as appropriate, and the probability of principal and interest payment default.
- An NAIC designation reflects the appropriateness and consistency of the RBC model factor that will be applied to the security given its level of risk.
- An NAIC designation must be considered in the context of its appropriateness and consistency of use in the NAIC Policy SFRS.

The SVO believes that these changes will improve clarity as to the purpose of NAIC designations in these two sections of the P&P Manual and how they should be interpreted by anyone using an NAIC designation. The SVO recommends that this amendment also be exposed for a 45-day comment period.

Chris Anderson (Anderson Insights) said that Therriault’s presentation was different from the proposal itself and contained additional information. Anderson said he supports the idea of clarifying the definition of an NAIC designation and noted that the proposal itself makes it clear that an NAIC designation is a credit designation and does not involve liquidity or call features. In summary, Anderson said he thinks the proposal should be focused not on how an NAIC designation is used and perhaps abused, which he said seems to be the focus of this proposal. If the objective is to clarify the definition of an NAIC designation, it should be clarified. An NAIC designation is consistent in the P&P Manual as it relates to credit, and he said part of this proposal is spot on. Credit is the ability and willingness of an obligor to make payments. A credit rating encompasses any reason that an obligor may fail. It does not matter what kind of asset it is. Credit rating on a scale of 1–20 reflects the probability of timely payment or default. Some of the language proposed is appropriate. Some of the other language, such as consistency, is not relevant to the definition of what an NAIC designation is. An NAIC designation is only credit. These thoughts should be referred to the Capital Adequacy (E) Task Force so that there can be consistency throughout the NAIC as to the meaning of an NAIC designation because RBC factors for bonds and preferred stock are based on the concept of credit.

Mears said Therriault detailed the reasons NAIC designations are unique, and clearly credit is a major component of that. They are used really for the sole purpose of the insurance regulatory framework, and RBC is a large part of that. The way that those are intertwined cannot be denied, and there is a connection that needs to be acknowledged. She said that Anderson’s point as to the timely and ultimate payment of principal and interest is something the Task Force is concerned with, and it can be discussed further upon receipt of his letter.

Mears directed staff to expose the proposed amendment to clarify the definition of an NAIC designation in Part One and Part Two of the P&P Manual for a 45-day public comment period ending Dec. 5.

5. Discussed Any Other Matters

Kolchinsky said regarding the interval release of the residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS), data reflect the 20 NAIC designation categories, and recent developments should be released around Oct. 31.

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

[https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-12 - Fall National Meeting/01-Minutes/Att One VOSTF 10.20.22 Minutes v6 \(FINAL\).docx](https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-12 - Fall National Meeting/01-Minutes/Att One VOSTF 10.20.22 Minutes v6 (FINAL).docx)

Draft Pending Adoption

Draft: 8/23/22

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

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

1. Adopted its June 9 and Spring National Meeting Minutes

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

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

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

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

Marc Perlman (NAIC) said the SVO has historically worked with statutory accounting colleagues to make accounting and reporting determinations, which guided whether the SVO could analyze and designate an insurer's investment. However, the P&P Manual currently provides conflicting guidance on whether the SVO should have a role interpreting accounting and reporting guidance. Paragraphs 32, 33, and 34 of Part One of the P&P Manual state that: 1) the assessment of an investment's credit risk is distinct from the determination of statutory

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accounting or reporting under the *Accounting Practices and Procedures Manual* (AP&P Manual); 2) accounting and reporting determinations for investments are the obligation of the insurance company, but state insurance regulators remain the final authority; and 3) the SVO may assign NAIC designations to any investment filed with it for which it has a methodology. However, it is also specified in Part One, paragraph 40 that the SVO is assigned to assess investments reported only on Schedules D and BA and shall communicate to insurers if an investment is not eligible for those schedules and can therefore not be assigned an NAIC designation. The SVO recommends amending paragraph 40 to provide consistent instructions to the SVO regarding its accounting and reporting guidance authority. The proposal would clarify, in accordance with Part One, paragraph 34, that the SVO can assign NAIC designations to investments that it does not believe are eligible for Schedule D or BA reporting so long as it has the methodology to do so. However, the SVO would have the authority, at its discretion, to notify the appropriate state insurance regulators of any investments that, in its opinion, would not or might not be eligible for reporting on Schedules D or BA. The SVO would also maintain its authority to offer its accounting and reporting opinion, when requested to do so, as part of its Regulatory Treatment Analysis Service (RTAS), it being understood that such opinions would not be authoritative and might not reflect the opinion of the relevant state insurance regulator. Also, to be clear, the SVO would not be required to designate investments that deviate from specific guidelines in the P&P Manual for that investment type. For example, for the SVO to designate a working capital finance investment (WCFI), the investment will still need to meet the very specific WCFI guidelines currently in the P&P Manual.

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

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

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

Chris Anderson (Anderson Insights LLC) said he hopes there would be symmetry between what the analyst at the SVO considers to be a bond and what will appear in the statutory accounting principles. Designations and credit ratings are expressions of the probability of payment on a scale of 1 to 20. If there is a probability of payment on a scale of 1 to 20, that indicates that the asset is a bond. It does not mean state insurance regulators should not

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have additional information about what kind of bond it is, but it seems that the most important element of investing in fixed income is whether there will be repayment. When the SVO or another analyst has expressed a considered view, reviewing all the facts and circumstances in an individual asset, it would seem to be compelling evidence. Mr. Anderson also hopes there will be coordination between the Task Force, the Statutory Accounting Principles (E) Working Group, and Capital Adequacy (E) Task Force.

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

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

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

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

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

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

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

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

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

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

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and performance asset, the likelihood of payment of the performance asset premium, whatever the amount might be, is linked directly to the creditworthiness of the issuer.

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

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

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

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

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

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

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

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

First, the Risk-Focused Surveillance (E) Working Group is considering the material terms of the investment management agreements (IMAs) and whether they are arm's length or include conflicts of interest. In the state insurance regulator discussions, it was noted, "Given the increasing prevalence of bespoke agreements, does it

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make sense to tie this work in to the work of the NAIC Valuation of Securities (E) Task Force and/or the NAIC Securities Valuation Office? If yes, how best to do so?”

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

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

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

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

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

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

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

The first new charge is consistent with the fixed income analytical risk measures that will be discussed later. The second new charge is a continuation of the existing charge I that says the Task Force will “Implement policies to oversee the NAIC’s staff administration of rating agency ratings used in NAIC processes, including staff’s discretion

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over the applicability of their use in its administration of filing exemption.” This charge would begin establishing when staff’s discretion is permitted.

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

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

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

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

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

Ms. Mears said the next item is to receive, discuss comments, and consider next steps on a proposal to add fixed income analytical measures for investments reported on Schedule D, Part One. This was first discussed at the Spring National Meeting and at the June 9 meeting. The proposed new fields will not only support the SVO’s analytical processes, but they also align with the regulatory initiatives of the Capital Adequacy (E) Task Force, the Life Actuarial (A) Task Force, and concerns expressed by the Financial Stability (E) Task Force and its Macroprudential (E) Working Group, which looks at industry-level and systemic risk, including their plans to build regulatory dashboards to reflect those risks. The commonly used bond analytical fields in this request are interconnected, one way or another, to the investment risk analysis being performed by these other regulatory groups and will ultimately benefit the NAIC by strengthening its overall regulatory framework. This request is not new and relates back to the 2010 recommendation from the Rating Agency (E) Working Group to look for an alternative way to measure risk, but its implementation is long overdue.

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

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

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the feedback from industry that this would be operationally burdensome, and it wants to look at alternative ways to collect this information.

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

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

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

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

- Assisting in SVO identification of securities with CRP ratings, which may be inconsistent with a security's actual overall risk for NAIC purposes.
- Greater transparency for state insurance regulators into the risks and characteristics of insurer investments and portfolios.
- Incorporation of insurer investment portfolio analysis into the examination process.
- Allowing state insurance regulators to assess the capabilities of an insurer's investment management or risk management processes by reviewing the quality and accuracy of the market data fields.

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

The second alternative would be to have insurers calculate this information and provide it to the NAIC, as originally proposed. As noted in the memo, insurer's investment managers should already have the market data fields

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

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

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

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

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

Mr. Anderson said the objectives stated here are certainly laudable. The question is whether it is time now to decide which data needs to be assembled to accomplish those objectives. First, NAIC designations today are the same as nationally recognized statistical rating organization (NRSRO) ratings as they relate to credit risk, ability, and willingness to pay on a scale of 1 to 20. What the staff memo talks about for the first time here is something that has been discussed as investment risk and now been renamed actual overall risk. Actual overall risk, which includes liquidity and any number of other elements, is interesting to state insurance regulators and important, but it is not part of today's structure. If there is a desire to broaden the notion of overall risk from today's structure, which is credit risk, or default risk, then tools need to be developed for state insurance regulators with them and their input in mind because it would be very unfortunate to develop a dashboard or something that is not useful at the examination level. Before a determination is made as to which data elements should be required, some work should be done on a workbench to see what kind of product can be developed using those inputs. It is not appropriate to use investment risk or actual overall risk to evaluate the performance of the rating agencies. The NRSROs are not looking at the overall investment risk; they are looking at what the NAIC looks at for C1 and R1,

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and that is default risk. RBC is presently structured to consider and measure default risk; then, within the structure, it deals with things like recovery, concentration, and other elements, but it would be inappropriate to use anything other than the present designation method, which is the same as rating agency metrics to judge a rating agency. There are other ways to judge a rating agency, and that is one of the things the Office of Credit Ratings (OCR) of the U.S. Securities and Exchange Commission (SEC) has offered up—the performance measurement data—which is published in a uniform standard for NRSROs. There are other methods, but the idea of using something other than credit default metrics to evaluate the performance of a rating agency is inappropriate.

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

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

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

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

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

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

The SVO recommends exposing the definitional updates to Part Two of the P&P Manual, which include the new illustrations, and deferring the proposed Part Three instructions to remove securities with Other Non-Payment Risks from FE. This deferral is intended to give industry sufficient time to provide examples of securities that are publicly rated by different CRPs, which have any of the three characteristics just listed for which there was not consensus, so the SVO can study them.

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

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

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

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

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

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

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

As for performance, the historical performance of CLOs has been good; this is especially true for the top of the capital stack. The recommended action is designed to allow insurers to continue participating in the CLO market without the risk that aggressive structuring puts policyholders and the investments in jeopardy. Given the performance of CLOs, some respondents commented that staff have not justified RBC at the 75% and 100% level.

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The current system works well if the intrinsic price is 70 or above since the highest RBC is currently 30%. A good example comes from the 2008 financial crisis, where a mezzanine residential mortgage-backed securities (RMBS) tranche was evaluated with an intrinsic price of 5. The resulting RBC was far below the risk evaluated. This may also occur in the residual tranches, such as CLO equity, if cash flows are interrupted to protect senior tranches. There will be plenty of opportunity for commenting about modeling, and there will be plenty of opportunities to discuss the comments related to modeling, transparency, and methodology.

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

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

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

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

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

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

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

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

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

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

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

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

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

13. Received an Update from the SSG on Modeling Scenarios

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

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

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

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

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

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



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

FROM: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau
Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

RE: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office
(the "P&P Manual") to Include Collateralized Loan Obligations (CLO) as a Financially Model
Security in Part Four

DATE: September 16, 2022

Summary – A collateralized loan obligation (CLO) is type of structured security backed by a pool of debt, typically corporate loans with low credit ratings. An insurer that purchases every tranche of a CLO holds the exact same investment risk as if it had directly purchased the entire pool of loans backing the CLO. The aggregate risk-based capital (RBC) factor for owning all of the CLO tranches should be the same as that required for owning all of the underlying loan collateral. If it is less, it means there is risk-based capital (RBC) arbitrage. As noted in the Investment Analysis Office's (IAO) memo of May 25, 2022, "Risk Assessment of Structured Securities – CLOs", it is currently possible to materially (and artificially) reduce C1 capital requirements just by securitizing a pool of assets.

Recommendation – The Investment Analysis Office recommends the Task Force assign the Structured Securities Group (SSG) the responsibility of financially modeling CLO investments. SSG can model CLO investments and evaluate all tranche level losses across all debt and equity tranches under a series of calibrated and weighted collateral stress scenarios to assign NAIC Designations that create equivalency between securitization and direct holdings, thereby eliminating RBC arbitrage.

The Task Force sent a referral to the Capital Adequacy (E) Task Force (CATF) and its Risk-Based Capital Investment Risk and Evaluation (E) Working Group (RBCIREWG) requesting those groups consider adding two new RBC factors. These recommended new RBC factors would account for the tail risk in any structured finance tranche. Staff also recommends adding NAIC Designation Categories (e.g. 6.A, 6.B and 6.C) with possible interim RBC factors of 30%, 75% and 100%, respectively, until those groups can further study structured securities. Staff request approval to draft a Blanks proposal for the new NAIC Designation Categories.

Proposed Amendment - The proposed text changes to P&P Manual are shown below with additions in red underline, deletions in ~~red strikethrough~~ as it would appear in the 2022 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.
 - **CLO** stands for collateralized loan obligation and means structured securities backed by a pool of debt, typically corporate loans with low credit ratings. The loans are managed by a collateral manager which bundles the initial loans (generally 150 or more) together and then actively manages the portfolio -- buying and selling loans. To fund the purchase of new debt, the CLO manager sells various tranches of the CLO to outside investors, such as insurers. Each tranche differs based on the order in which the investors will be paid when the underlying loan payments are made. As a result, they also differ with respect to the risk associated with the investment since investors who are paid last have a higher risk of default from the underlying loans. To compensate for the risk, the interest coupon payments on the subordinate tranches are higher. Investors who are paid out first have lower overall risk, but they receive smaller interest coupon payments, as a result.
 - **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 **CLO**, 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.
- **Intrinsic Price** is an output of financial modeling, defined as ‘1 – weighted average of discounted principal loss’ expressed as a percentage, reflecting the credit risk of the security.
- **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.
- **NAIC Designation Intrinsic Price Mapping** is the mapping of the Intrinsic Price to a single NAIC Designation and Designation Category employing the midpoints between each adjoining AVR RBC charges (pre-tax). The midpoints are directly used as the minimum Intrinsic Prices (weighted average loss points) for corresponding NAIC Designations and Designation Categories.
- **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 **CLO**, 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 **CLO**, 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 **CLO**, 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 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 and application of Price Grids described in this Part.
 - **FMR** – Indicates that the specific CUSIP identifies a Legacy Security RMBS that is subject to the financial modeling methodology and the application of Price Grids to determine a NAIC Designation and Designation Category.
 - **FMC** – Indicates that the specific CUSIP identifies a Legacy Security CMBS that is subject to the financial modeling methodology and the application of Price Grids to determine a NAIC Designation and Designation Category
 - Non-Legacy RMBS and CMBS subject to the financial modeling methodology would be assigned an NAIC Designation and Designation Category by the SSG without an administrative symbol.
 - **CLO subject to the financial modeling methodology would be assigned an NAIC Designation and Designation Category by the SSG without an administrative symbol.**

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 Legacy Security modeled RMBS and CMBS CUSIPs. The symbol **FM** is inserted by the insurer in the financial statement as a suffix following the NAIC Designation Category for Legacy Security RMBS and CMBS; (e.g., **2.B FM**), and for **CLO and** Non-Legacy RMBS and CMBS it would be left blank (e.g. **3.C**).

The use of these administrative symbols in the VOS Product means the insurer should not use the filing exempt process for the security so identified.



Quarterly Reporting of RMBS and CMBS

3. To determine the NAIC Designation to be used for quarterly financial statement reporting for a **CLO**, RMBS or CMBS 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) and follows the instructions in contained under the heading "Use of Net Present Value and Carrying Value for Financially Modelled Legacy Security RMBS and CMBS" or "Use of Intrinsic Price for Financially Modelled non-Legacy Security RMBS and CMBS" below, subject to, and in accordance with, *SSAP No. 43R—Loan-Backed and Structured Securities*.



FILING EXEMPTIONS

Limited Filing Exemption for RMBS and CMBS

4. **CLO, RMBS and CMBS that Can be Financially Modeled** – CLO, RMBS and CMBS that can be financially modeled are exempt from filing with the SVO. NAIC Designations for CLO, RMBS and CMBS that can be financially modeled are determined by application of the methodology discussed in this Part, not by the use of credit ratings of CRPs.
5. **CLO, RMBS and CMBS securities that Cannot be Financially Modeled**
 - **But Are Rated by a CRP** – CLO, 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 for these CLO, RMBS and CMBS are determined by application of the filing exemption procedures discussed in this Manual.
 - **But Are Not Rated by a CRP** – CLO, 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 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, including, but not limited to, a Price Grid or for assignment of an NAIC Designation. 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 **CLO**, 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. A **CLO**, 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 **CLO**, 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 **CLO**, 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. A **CLO**, 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 **CLO**, RMBS or CMBS was reviewed by SSG through an Initial Sufficiency Filing; or
- **Safe Harbor** – The **CLO**, 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 a **CLO**, 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 **CLO**, RMBS or CMBS. Reporting insurance companies are solely responsible for providing the SSG with Initial Information. A determination by the SSG that a given **CLO**, 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 a **CLO**, RMBS or a CMBS for which Initial Information is not publicly available shall provide the SSG with the following documentation.
13. **CLO** – Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for a CLO 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
 - All eligible CRP ratings for underlying loan portfolio.
 - For each unrated underlying loans, the Prospectus, Offering Memorandum or similar; 3-years of audited financial statements for the issuing entity.
14. **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
15. **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
 - 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

16. 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

17. 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. A **CLO**, 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

18. A **CLO**, 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 **CLO**, 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

19. 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 **CLO**, RMBS AND CMBS – MODELED AND NON-MODELED SECURITIES

Scope

20. This section explains the financial modeling methodology applicable to all **CLO**, RMBS and CMBS (defined above) securitizations, the book/adjusted carrying value methodology applicable to a modeled Legacy Security, the NAIC Designation Intrinsic Price Mapping applicable to a modeled non-Legacy Security, 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

21. The definitions of **CLO**, RMBS and CMBS above are intended solely to permit the SSG to communicate with financial modeling vendors, insurance company investors who own **CLO**, 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 **CLO**, RMBS AND CMBS SECURITIZATIONS SUBJECT TO FINANCIAL MODELING METHODOLOGY

Filing Exemption Status of RMBS and CMBS

22. **CLO**, RMBS and CMBS are not eligible for filing exemption because credit ratings of CRPs are no longer used to set risk-based capital (RBC) for **CLO**, RMBS or CMBS. However, **CLO**, RMBS and CMBS are not submitted to the SSG.



Use of Financial Modeling for Year-End Reporting for **CLO**, RMBS and CMBS

23. Beginning with year-end 2009 for RMBS, and 2010 for CMBS, probability weighted net present values will be produced under NAIC staff supervision by an NAIC-selected vendor using its financial model with defined analytical inputs selected by the SSG. The vendor will provide the SSG with a Intrinsic Price and/or a range of net present values for each RMBS or CMBS corresponding to each NAIC Designation category. The NAIC Designation for a specific Legacy Security RMBS or CMBS is determined by the insurance company, based on book/adjusted carrying value ranges, and the NAIC Designation for a specific non-Legacy Security RMBS or CMBS is determined by the NAIC Designation Intrinsic Price Mapping by SSG.
24. Beginning with year-end 2023 for CLO, probability weighted net present values will be produced by SSG with defined analytical inputs selected by the SSG. SSG will model CLO investments and evaluate all tranche level losses across all debt and equity tranches under a series of calibrated and weighted collateral stress scenarios to assign NAIC Designations for a specific CLO tranche is determined by the NAIC Designation Intrinsic Price Mapping by SSG.

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

Analytical Procedures for **CLO**, RMBS and CMBS

25. 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 CLO, RMBS and CMBS using the vendor's proprietary models.

CLO, RMBS AND CMBS SUBJECT TO FINANCIAL MODELING

Setting Microeconomic Assumptions and Stress Scenarios

26. 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

27. Information about the financial modeling process can be found at www.naic.org/structured_securities/index_structured_securities.htm.



Use of Net Present Value and Carrying Value for Financially Modeled Legacy Security RMBS and CMBS

28. For each modeled Legacy Security RMBS and CMBS, the financial model determines the net present value 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.

RBC charge / NAIC designation (pre-tax)

P&C	RBC	Midpoint
1	0.3%	0.65%
2	1.0%	1.50%
3	2.0%	3.25%
4	4.5%	7.25%
5	10.0%	20.00%
6	30.0%	
Life	RBC	Midpoint
1	0.4%	0.85%
2	1.3%	2.95%
3	4.6%	7.30%
4	10.0%	16.50%
5	23.0%	26.50%
6	30.0%	



29. The NAIC Designation and NAIC Designation Category for a given modeled Legacy Security 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 and the mapped NAIC Designation Category, reflected in the table below, to be used for reporting an NAIC Designation Category until new prices ranges are developed to reflect the full range of new Risk Based Capital factors adopted for each NAIC Designation Category; except that a modeled Legacy Security RMBS or CMBS tranche that has no expected loss under any of the selected modeling scenarios would be assigned an **NAIC 1 Designation** and **NAIC 1.A Designation Category** regardless of the insurer's book/adjusted carrying value.

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

<u>NAIC Designation</u> <u>Determined by</u> <u>Modeled Price Ranges</u>	<u>Mapped NAIC</u> <u>Designation Category</u>
1	1.D
2	2.B
3	3.B
4	4.B
5	5.B
6	6

Use of Intrinsic Price for Financially Modeled **CLO and** non-Legacy Security RMBS and CMBS

30. The NAIC Designation and NAIC Designation Category for a given modeled **CLO and** non-Legacy Security RMBS or CMBS CUSIP owned by a given insurance is assigned by SSG and **does not** depend on the insurer's book/adjusted carrying value of each **CLO**, RMBS or CMBS. The NAIC Designation and Designation Category assigned will be determined by applying the Intrinsic Price to the NAIC Designation Intrinsic Price Mapping, as defined in this Part.



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

31. 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**, NAIC Designation Category **NAIC 5.B GI** or **NAIC 6*** (six-star)].



MORTGAGE REFERENCED SECURITIES

Definition

32. A Mortgage Referenced Security has the following characteristics: 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.

Not Filing Exempt

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

NAIC Risk Assessment

34. In determining the NAIC Designation of a Mortgage Referenced Security, the SSG may use the financial modeling methodology discussed in this Part, adjusted (if and as necessary) to the specific reporting and accounting requirements applicable to Mortgage Referenced Securities.

Quarterly Reporting for Mortgage Reference Securities

35. 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.

NOTE: Please refer to SSAP No. 26R and SSAP No. 43R for the definition of and guidance on Structured Notes and Mortgage Referenced Securities. Please also refer to Part Three of this Manual for guidance about the filing exempt status of Structured Notes.



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.



THE RTAS – EMERGING INVESTMENT VEHICLE

Purpose

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

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

Extension of Authority

39. 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 **CLO**, 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

40. 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 and/or NAIC Designations and Designation Categories

41. Price Grids and/or Designations and Designation Categories (“PGD”) 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 **CLO**, 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 and/or Designations and Designation Categories (“Preliminary PGD”) into official PGD that can be used for NAIC regulatory purposes. Preliminary PGDs generated by the SSG become an official PGD within the meaning of this section when an insurance company has purchased the security for which the PGD was generated and reported that security for quarterly reporting purposes using the SSG generated PGD. A PGD 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 the time the PGD generated by the SSG at year-end shall be the official PGDs for that security.

Steve Clayburn, FSA, MAAA
Senior Actuary, Health Insurance & Reinsurance
steveclayburn@accli.com

December 5, 2022

Ms. Carrie Mears, Chair
Valuation of Securities (E) Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Via email: ctherriault@naic.org and dgenaorosado@naic.org

Re: Amendment to Part Four of the Purposes and Procedures Manual ("P&P Manual") of the NAIC Investment Analysis Office to Include Collateralized Loan Obligations ("CLO")

Dear Ms. Mears:

ACLI appreciates the opportunity to provide comments on the Valuation of Securities Task Force's (VoSTF) exposure to update Part Four of the P&P Manual to include CLOs. Our suggestions are to help clarify the exposed edits for ease of reading and/or correctly outlining information associated with CLOs for the VoSTF to reconsider and clarify some of the updates, including some of the unedited sections that had CLOs added.

In the "Definitions" section, we suggest the following edits (underline new, ~~striketrough~~ delete):

- **CLO** stands for collateralized loan obligation and means structured securities backed by a pool of debt, typically corporate loans with low credit ratings. The loans are managed by a collateral manager which bundles the initial loans (for example, generally 150 or more) together and then actively manages the portfolio -- buying and selling loans. To fund the purchase of new debt, the CLO manager sells various tranches of the CLO to outside investors, ~~such as~~ which could include insurers. Each tranche differs based on the priority ~~order~~ in which the investors will be paid when the underlying loan payments are made. As a result, they also differ with respect to the risk associated with the investment since investors who are in lower tranches ~~paid last~~ have a higher risk of default from the underlying loans. To compensate for the risk, the interest coupon payments on the subordinate tranches are higher. Investors who are in higher tranches ~~paid out first~~ have lower overall risk, but they receive smaller interest coupon payments, as a result.

While reviewing other definitions that had "CLOs" added as a structured security, we note the following issues/questions regarding the following:

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The American Council of Life Insurers (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

Initial Information means the documentation required to be filed with an Initial Filing of an CLO, RMBS or a CMBS CUSIP, pursuant to the section below and pertaining to Loan Information, Reps and Warranty Information and Structure (other than for CLOs) 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. **Comment:** *In the context of CLOs, can there be clarification as to what specific information for CLOs is needed? For example, "title" is not relevant for CLOs.*
- 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). **Comment:** *We suggested the additional phrase above as 'reps and warranty information' is not relevant for BSL CLOs as they do not originate loans. In addition, given the revolving nature of CLO pools versus static MBS or other ABS pools, "defective" put back rights are not applicable.*
- 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, to the extent provided by counsel. **Comment:** *'Bankruptcy remoteness and true sale opinions' are not provided for CLOs. As the purchases are made in the open market, true sale concerns are not implicated. Additionally, the insurer will form a fully orphaned special purpose vehicle (SPV), thus rating agencies and the industry appear comfortable with the overall structure from a bankruptcy remoteness perspective.*

Ongoing Information, if relevant for the structured security being reviewed, 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 typically provided by the trustee in payment date reports 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. **Comment:** *Industry notes that some of the requirements in this section are not applicable to CLOs (e.g., allocated realized losses and appraisal reductions), thus the above suggested edits. Furthermore, for CLOs, we ask for clarification on 'loan level performance information' – currently no loan performance is being published.*

In the "Initial Sufficiency Information Filing" section, new paragraph 13, it appears that much of the information was assumed to be similar to RMBS and CMBS. CLOs are not the same and thus we explain the differences and provide suggestions to clarify this list where possible.

“CLO – Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for a CLO consists of submission of Initial Information and Ongoing Information in the form of the following documentation:

- Pooling and Servicing Agreement or similar **Comment:** *In the CLO context this would be the Indenture – Suggest replacing this item with Indenture.*
- Prospectus, Offering Memorandum or similar; Accountant’s comfort letter, if obtained in connection with such transaction. **Comment:** *The offering memorandum will be available but just covers what is in the Indenture. The accountant’s comfort letter in CLOs is usually just for the effective date procedures, which comes months after the ratings, as CLOs are not fully “ramped” when first closed, and the portfolio can change over time, unlike mortgage-back securities (“MBS”).*
- If applicable, ISDA Schedules and Confirmations or similar **Comment:** *Approximately 99.9% of the time there will be no hedges for CLO transactions.*
- Legal opinions given in connection with the transaction **Comment:** *This information is shared with rating agencies by the creator of the CLOs. As an investor in a deal, the legal opinions are not provided.*
- Any other documents referenced by the above **Comment:** *An investor in CLOs will usually receive the prospectus and indenture.*
- Third-Party Due diligence scope document and raw results. If less than 100% due diligence, detailed description of the loan selection process **Comment:** *Unlike MBS, BSL CLOs are not sold with third-party due diligence – Suggest deleting this item.*
- If applicable, loan purchase agreements or similar. **Comment:** *This too is an MBS concept due to the way that MBS loans are pooled before entry into the REMIC structure. Not applicable to “open-market CLOs” which is most BSL CLOs. – Suggest deleting this item.*
- Loan Tape **Comment:** *This concept does not truly apply to CLOs because the transactions as mentioned ramp up post-closing of the deal. One could consider the closing date portfolio as the best analogy, but since the CLO portfolio can be traded it is very different than the static MBS portfolio concept. Suggest deleting this item.*
- All eligible CRP ratings for underlying loan portfolio. **Comment:** *This should not be an issue; however, the same caveat mentioned above (i.e., the portfolio changes) might play a role.*
- For each unrated underlying loans, the Prospectus, Offering Memorandum or similar; 3-years of audited financial statements for the issuing entity. **Comment:** *For BSL CLOs all loans will have a major rating agency rate it – obtaining all required information listed might be an issue (e.g., obtaining 3 years audited financials. This will not be the case when middle market CLOs are modeled. Which raises the following question - Are middle market CLOs also within the scope of this update?*

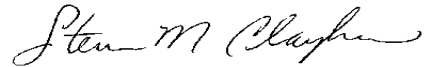
In the “Use of the Financial Modeling for Year-End Reporting for CLO, RMBS, and CMBS”, new paragraph 24, we would suggest the following edits since many important decisions have not been decided at this time:

Beginning with the year-end, once decisions of modeling and its assumptions are complete ~~2023~~ for CLOs, probability weighted net present values will be produced under NAIC staff supervision ~~by SSG~~ using its financial model with defined analytical inputs selected by the SSG. ~~SSG will~~ Modeling CLO investments and evaluating all tranche level losses across all debt and equity tranches under a series of calibrated and weighted collateral stress scenarios to assign NAIC Designations for a specific CLO tranche ~~is~~ will be determined by the NAIC. ~~Designation Intrinsic Price Mapping by SSG.~~

12/14/22

Thank you for the opportunity to continue to participate and comment on this issue. We look forward to future discussions and continued collaboration with the NAIC on this important initiative.

Sincerely,

A handwritten signature in cursive script, reading "Steve M. Clayburn".

Steve Clayburn

cc: Paul Graham, ACLI
Mike Monahan, ACLI



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

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

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

RE: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office
(the "P&P Manual") regarding Subsidiary, Controlled and Affiliated (SCA) Debt or Preferred Stock Investments

DATE: September 16, 2022

Summary – On June 10, 2022 the Statutory Accounting Principles (E) Working Group sent a referral to the Task Force resulting from the Working Group's May 24, 2022 adoption of agenda item 2021-21: *Related Party Report* which revised both *SSAP No. 25 – Affiliates and Other Related Parties* and *SSAP No. 43 – Loan-Backed and Structured Securities* which raised comments about eligibility for filing exemption for various affiliated structures.

The amendment required new reporting information for investments that involve a related party as sponsor, originator or other similar transaction party, regardless of whether the investment is captured on the affiliate reporting line. The referral further explained that because the definition of affiliation is determined by an evaluation of control of the issuer, which for structure securities is typically a special purpose entity (SPE), it is possible for an investment that involves an affiliate or related party issuer to not be considered affiliated (because the insurer has no control over the issuing SPE), while it is also possible for an affiliated debt investment to lack underlying affiliated credit exposure (because the underlying obligors are not affiliate or related parties).

The Working Group referred this matter to the Task Force stating that, "the SVO may need to develop additional procedures to add a methodology to designate this type of asset-backed security investment structure, or to clarify that affiliated investments that do not have underlying affiliated credit exposure [meaning the affiliate exposure is to the SPE issuer, originator, sponsor or servicer rather than the underlying obligor] qualify for FE."

The Subsidiary, Controlled and Affiliated (SCA) Debt or Preferred Stock Investments section of the P&P Manual currently only requires insurers to file with the SVO bonds or preferred stock issued by an insurance or non-insurance SCA entity. Therefore, a transaction with an affiliate or related party obligor, sponsor or underlying obligor, as opposed to issuer, or other non-issuer party which transfers risk, directly or indirectly, to the reporting insurance company, would not constitute an SCA investment as currently

defined. Transactions in which the issuer is not an affiliate or related party could, nonetheless, and as stated in SSAP No. 25, be “subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic reality or may not be fair and reasonable to the reporting entity or its policyholders.” For example, an affiliated or related entity could originate several loans to unaffiliated and unrelated obligors and, for various reasons, sell those loans to a SPE which could then issue a note to the reporting insurance company. The fact the reporting insurance company is assuming the risk of the loans originated by an affiliate or related party could pose risks of abuse or unfairness even though the underlying loan obligors (the credit exposure) are not affiliates or related parties. A similar risk of possible abuse exists if the underlying credit exposure has a relationship to the reporting insurance company, even if the issuer does not. Therefore, the amendment would also make investments ineligible for filing exemption if the underlying credit exposure would qualify as a related party pursuant to paragraph 4.a. in *SSAP No. 43R – Loan-Backed and Structured Securities*, even if the issuer is not an SCA or related party.

Transactions with an affiliate or related party that is not the issuer (typically a securitization or other structured finance structure) are currently eligible for filing exemption. Such investments, however, would likely be in scope of *SSAP No. 25—Affiliates and Other Related Parties* and subject to reporting as an affiliate or related party transaction in the appropriate investment schedules. State insurance regulators could, based upon the reporting of an affiliate or related party relationship, require that the reporting insurance company file an investment with the SVO for analysis and/or assignment of an NAIC Designation.

Additionally, while we are opening up the SCA section for revisions, the SVO proposes clarifying that SCA investments, according to the P&P Manual, has always referred not only to affiliate transactions in which there is direct or indirect control between the reporting insurance company and a transaction entity, but referred also to related parties where relationships other than control, as listed in SSAP No. 25, might exist. For example, the SVO reviewed a transaction in which there was no direct or indirect control between the reporting entity and the issuer, but there was a father/son relationship between the owner of the issuer and CEO of the reporting insurance company, a relationship which poses a risk of abuse, unfairness, or unreasonableness.

Recommendation – The SVO proposes renaming the Subsidiary, Controlled and Affiliated (SCA) Debt or Preferred Stock Investments section of the P&P Manual to Subsidiary, Controlled and Affiliated (SCA) and Related Party Debt or Preferred Stock Investments to clarify that it includes non-control relationships, and amending SCA investment, SCA debt and SCA preferred stock definitions to include related parties.

The SVO also proposes expanding the definition of SCA and related party debt to include structures in which the non-issuer underlying credit exposure would qualify as a related party pursuant to paragraph 4.a. in *SSAP No. 43R – Loan-Backed and Structured Securities*.

Lastly, the SVO also proposes creating a new category of SCA and related party investment called SCA and Related Party Filing Exempt Investments which would mean any investment (i) issued by an affiliate or related party special purpose entity (SPE) which itself is not an obligor or ultimate source of the investment repayment, or (ii) issued as part of a structure in which the originator, sponsor, manager, servicer, other influential transaction party is an affiliate or related party of the reporting insurance company. SCA and Related Party Filing Exempt Investments would be eligible for filing exemption unless otherwise ineligible (for reasons other than their affiliate or related party status). The P&P Manual would also be amended to clarify that state insurance regulators are permitted, as specified in Part One of the P&P, to require an insurance company to file what would otherwise be an SCA and Related Party Filing Exempt Investment for analysis and/or assignment of an NAIC Designation only by the SVO, thereby making it ineligible for filing exemption in the future.

Proposed Amendment - The proposed text changes to P&P Manual are shown below with additions in red underline, deletions in ~~red strikethrough~~ as it would appear in the 2022 P&P Manual format.

PART ONE

POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

...

SUBSIDIARY, CONTROLLED AND AFFILIATED <u>(SCA) AND RELATED PARTY</u> INVESTMENTS

110. SCA and related party bond and preferred stock investments (each, as defined in Part Three) in the form of a debt instrument purchased (or otherwise acquired) from an insurance or non-insurance entity ~~(SCA debt)~~ and preferred stock issued by an insurance or non-insurance entity ~~(SCA preferred)~~ may be assessed by the SVO to determine eligibility for reporting as an Investment Security as defined in this Manual. The SVO is required to determine that a filed SCA and related party investment has terms, structure, complexity and purpose like those in transactions between unaffiliated parties so that credit risk assessment methodologies applied to transactions between unaffiliated parties can be meaningfully applied to transactions between affiliated parties; as a condition to assigning an NAIC Designation to the investment.

NOTE: See “Subsidiary, Controlled and Affiliated (SCA) and related party Debt Bond or Preferred Stock” in Part Three for filing instructions, documentation requirements and methodology applicable to SCAs.

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

Filing Exemption

3. Bonds, within the scope of SSAP No. 26R and SSAP No. 43R (excluding RMBS and CMBS subject to financial modeling) and Preferred Stock within scope of SSAP No. 32, that have been assigned an Eligible NAIC CRP Rating, as described in this Manual, are exempt from filing with the SVO (FE securities) with the exception of Bonds and/or Preferred Stock explicitly excluded below.

Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:

...

- **SCA and Related Party Bond and Preferred Stock Investments** – SCA and related party bond and preferred stock investments (each, as defined in this Part) are transactions between insurance company affiliates SCA's (as defined in SSAP No. 97—*Investments in Subsidiary, Controlled and Affiliated Entities*) (called or other related parties) (as defined in SSAP No. 25—*Affiliates and Other Related Parties*) that are subject to special regulatory considerations identified in SSAP No. 25—*Affiliates and Other Related Parties*. This Manual specifies that such **SCA and related party bond and preferred stock investments transactions** are not **subject to eligible for** filing exemption and can only be assigned an NAIC Designation if the SVO has first concluded that the transaction is like those the SVO typically assesses for credit risk. See the SCA **and Related Party** section in this Part for further information about how the SVO determines whether an SCA **and Related Party** investment will be assigned an NAIC Designation **and how a state insurance regulator can require an insurance company to file an otherwise filing exempt structure containing an SCA or related party with the SVO.**

**SUBSIDIARY, CONTROLLED AND AFFILIATED (SCA) AND RELATED PARTY DEBT BOND OR
PREFERRED STOCK INVESTMENTS**

NOTE: See “Policies Applicable to Specific Asset Classes” in Part One for the 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.

Filing Instructions

244. **Common Stock** – An investment in the form of common stock issued by an insurance or non-insurance subsidiary, controlled or affiliated (SCA) entity of the reporting insurance company or an investment in the form of a preferred stock issued by an insurance subsidiary, controlled or affiliated company of the reporting insurance company **is required to be filed with the NAIC Financial Regulatory Services Division** in the manner and form and with the documentation provided for in the Appendix to *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*.
245. **Bonds** – An investment in the form of a bond (i) issued by an insurance or noninsurance SCA ~~entity or related party~~ of the reporting insurance company (except for issuers that fit the example in subclause (i) of the “SCA and Related Party Filing Exempt Investments” section), or (ii) issued as part of a structure which would, pursuant to paragraph 4.a. of SSAP No. 43 – Loan-Backed and Structured Securities, qualify as a related party investment due to the reporting insurance company’s relationship with the underlying credit exposure (“SCA and related party bond”), is filed with the SVO. To file an SCA and related party bond investment, the reporting insurance company files an Audited Financial Statement for the subsidiary, a copy of the corporate resolution authorizing the issuance of the debt, written evidence that the transaction has been approved by the state of domicile or that no such approval is necessary and, if the subsidiary is an insurance company, the subsidiary’s most recent NAIC Financial Statement Blank, together with the reporting insurance company’s NAIC Financial Statement Blank, internal investment committee memorandum for the investment and loan documentation appropriate to the transaction.

246. **Preferred Stock** – An investment in the form of a preferred stock (i) issued by a noninsurance SCA ~~entity or related party~~ of the reporting insurance company (except for issuers that fit the example in subclause (i) of the “SCA and Related Party Filing Exempt Investments” section), or (ii) issued as part of a structure which would, pursuant to paragraph 4.a. of SSAP No. 43 – Loan-Backed and Structured Securities, qualify as a related party investment due to the reporting insurance company’s relationship with the underlying credit exposure (“SCA and related party preferred stock”), is filed with the SVO. To file an SCA and related party preferred stock issued by a non-insurer, the reporting insurance company files an Audited Financial Statement for the issuer of the preferred stock, a copy of the corporate resolution authorizing the issuance of the preferred stock, written evidence that the transaction has been approved by the state of domicile or that no such approval is necessary, together with details of the terms of the preferred stock, as well as the NAIC Financial Statement Blank for the reporting insurance company.

NOTE: Please see the section on preferred stock in this Part for additional analytical procedures applicable to that asset class.

247. **SCA and Related Party Filing Exempt Investments** – Certain investments might contain SCA or related party relationships with non-issuer or non-credit exposure entities. For example, an investment could be (i) issued by an SCA or related party special purpose entity (SPE) which itself is not an obligor or credit exposure, or (ii) issued as part of a structure in which the originator, sponsor, manager, servicer, other influential transaction party, is an affiliate or related party of the reporting insurance company. Such investments are eligible for filing exemption unless otherwise ineligible pursuant to guidance in this Manual unrelated to SCA or related party status. However, such investments may be in scope of SSAP No. 25—Affiliates and Other Related Parties and subject to reporting as an affiliate or related party transaction in the appropriate investment schedules. For the avoidance of doubt, nothing in this section prohibits a state insurance regulator, in accordance with Part One of this Manual, from requiring its domiciled insurance company to file an otherwise filing exempt investment with the SVO for analysis and/or assignment of an NAIC Designation, thereby making it ineligible for future filing exemption.

Purpose

248. This section applies to credit assessment of any SCA ~~and related party~~ investment in the form of a debt instrument purchased (or otherwise acquired) from an insurance or non-insurance entity (SCA ~~and related party debt bond~~) and preferred stock issued by an insurance or non-insurance entity (SCA ~~and related party~~ preferred stock). This procedure is used to determine whether an SCA ~~and related party debt bond~~ or SCA ~~and related party~~ preferred transaction is eligible for reporting as an Investment Security pursuant to this Manual. The determination of “Investment Security” and credit assessment provided by the SVO shall not be construed to reflect assessments specific to affiliated transactions contained in *SSAP No. 25—Affiliates and Other Related Parties*. As such, an SVO-assigned NAIC Designation for affiliated ~~and related party~~ transactions:

- Does not reflect collectability based on independent payment ability of a parent reporting entity.
- Does not reflect whether the transaction was conducted at arm’s-length.
- Does not reflect whether the transaction is considered “economic” under SSAP No. 25.

Notification Procedure

249. Prior to applying the procedures required below, the SVO shall:

- Confirm that the SCA relationship has been reported to the NAIC Financial Reporting Services Division, if required.
- If the SCA common ~~and~~ preferred stock transaction was reported (or if not required to be reported), the SVO shall:
 - Inform the state insurance department of the reporting insurance company’s state of domicile that the SCA ~~debt bond~~ or ~~SCA~~-preferred stock has been filed with the SVO.
 - Evaluate whether the SCA ~~debt bond~~ or ~~SCA~~ preferred stock transaction is circular within the meaning of that phrase as discussed in this Manual.
 - In the case of SCA preferred stock, determine the SCA preferred stock issuer’s senior unsecured debt designation and obtain the appropriate designation level for the preferred stock by applying the methodology specified in this Manual.

250. Although an NAIC Designation does not provide assurances regarding arm's-length or economic, if the SVO becomes aware of any information that indicates further review is warranted, the SVO shall contact the reporting entity to discuss, with subsequent notification (by the reporting entity or SVO) to the domiciliary state regulator, as needed. Pursuant to SSAP No. 25, affiliate transactions that are not arm's-length and/or economic are subject to additional accounting and reporting guidelines and each reporting entity is required to be knowledgeable about its domiciliary state regulatory requirements for approval of these transactions.

Definitions

251. The following definitions/concepts are from SSAP No. 25:

- **Arm's-Length** – An arm's-length transaction is defined as a transaction in which willing parties—each being reasonably aware of all relevant facts and neither under compulsion to buy, sell or loan—would be willing to participate.
- **Economic** – An economic transaction is defined as an arm's-length transaction which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof; i.e., “permanence.” The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. An economic transaction must represent a bona fide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance, not the form of the transaction.

Procedure for Credit Assessment of Filed SCA Transaction

252. The procedure specified in this section applies to bonds and preferred stock whose terms, structure, complexity and purpose are like those in transactions between unaffiliated parties filed with the SVO so that credit risk assessment methodologies applied to transactions between unaffiliated parties can be meaningfully applied to transactions between affiliated parties.

253. A determination that a bond or a preferred stock submitted for an assessment under this section is not like a transaction between unaffiliated parties and/or that analytical methodologies applied to transactions between unaffiliated parties cannot be meaningfully applied to the filed transaction shall be in the sole discretion of the SVO.

254. An insurer apprised of the SVO's determination may request a conference call with the SVO to evaluate whether focused disclosure and documentation pertaining to the terms, structure, complexity and purpose of the transaction may enable the SVO to develop a credit assessment methodology specific to the transaction. If the insurer and the SVO agree that a transaction specific credit assessment approach can be developed, administrative details pertaining to the conduct of the assessment shall be as negotiated between the SVO and the insurer.

255. Instead of filing a transaction under this section, an insurer may choose to file an RTAS submission (discussed in this Manual) to solicit an opinion and rationale from the SVO whether or not an SCA and related party transaction would be considered to be like those between unaffiliated entities or ask its domiciliary state regulator to consider requesting that the SVO assist the department in the determination of an NAIC Designation for the transaction under the Regulatory Transactions procedure discussed in this Manual.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-10-20 - Interim Meeting/03-Related Parties/2022-008.04_VOSTF_Amend_SVO_RelatedParties_v5.docx



Mike Monahan
Senior Director, Accounting Policy
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December 5, 2022

Ms. Carrie Mears, Chair
Valuation of Securities Task Force
National Association of Insurance Commissioners 110
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Re: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "P&P Manual") regarding Subsidiary, Controlled and Affiliated (SCA) Debt or Preferred Stock Investments

Dear Ms. Mears,

The undersigned (ACLI, PPIA, and NASVA) appreciate the opportunity to comment on the exposure referred to above that was released for comment by the Valuation of Securities Task Force (VOSTF) on October 20, 2022.

Our understanding of the changes being proposed to the P&P manual is that the changes clarify the two following points:

1. Affiliated or related party investments that do not have credit risk exposure to the affiliate or related party continue to be filing exempt even if they are reported as affiliated in the investment schedules.

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The American Council of Life Insurers (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

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PPIA is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PPIA serves 63 member companies and works with regulators, NASVA, the American College of Investors Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace.

NASVA is an association of insurance company representatives who interact with the NAIC Securities Valuation Office ("SVO") to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes.

2. The requirement to file with the SVO to obtain a designation for SCA debt and preferred stock investments that have credit risk exposure to the SCA also apply to related party investments where the insurer has credit risk exposure to the related party.

The undersigned agree with these concepts. However, we kindly suggest the edits included in the respective sections of the P&P manual below, highlighted in gray, which provide additional needed clarity to the proposed updates.

We stand ready to answer any questions related to our proposed changes. Sincerely,

Mike Monahan



Senior Director, Accounting Policy

Tracey Lindsey

Tracey Lindsey
NASVA

John Petchler

John Petchler
on behalf of PPIA
Board of Director

PART ONE

POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

...

Subsidiary, Controlled and Affiliated (SCA) and Related Party Investments

110. SCA and related party bond and preferred stock investments (each, as defined in Part Three) in the form of a debt instrument purchased (or otherwise acquired) from an insurance or non-insurance entity ~~(SCA-debt)~~ and preferred stock issued by an insurance or non-insurance entity ~~(SCA-preferred)~~ may be assessed by the SVO to determine eligibility for reporting as an Investment Security as defined in this Manual. The SVO is required to determine that a filed SCA and related party investment has terms, structure, complexity and purpose like those in transactions between unaffiliated parties so that credit risk assessment methodologies applied to transactions between unaffiliated parties can be meaningfully applied to transactions between affiliated parties; as a condition to assigning an NAIC Designation to the investment.

NOTE: See “Subsidiary, Controlled and Affiliated (SCA) and related party Debt Bond or Preferred Stock” in Part Three for filing instructions, documentation requirements and methodology applicable to SCAs.

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

Filing Exemption

3. Bonds, within the scope of SSAP No. 26R and SSAP No. 43R (excluding RMBS and CMBS subject to financial modeling) and Preferred Stock within scope of SSAP No. 32, that have been assigned an Eligible NAIC CRP Rating, as described in this Manual, are exempt from filing with the SVO (FE securities) with the exception of Bonds and/or Preferred Stock explicitly excluded below.

Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:

...

- **SCA and Related Party Bond and Preferred Stock Investments** – SCA **and related party bond and preferred stock** investments are comprised of two types of transactions **(each, as defined in this Part)** (1) SCA and related Party investments that have credit risk exposure to the SCA or related party, which are not filing exempt; and (2) SCA and related party investments that do not have any credit risk exposure to the SCA or related party and are filing exempt. Transactions under (1) are transactions between insurance company ~~affiliates~~ SCA's **(as defined in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities) (called or other related parties) (as defined in SSAP No. 25—Affiliates and Other Related Parties)** that are subject to special regulatory considerations identified in *SSAP No. 25—Affiliates and Other Related Parties*. This Manual specifies that such **SCA and related party bond and preferred stock investments transactions** are not ~~subject to~~ **eligible for** filing exemption and can only be assigned an NAIC Designation if the SVO has first concluded that the transaction is like those the SVO typically assesses for credit risk. See the SCA **and Related Party** section in this Part for further information about how the SVO determines whether an SCA **and Related Party** investment will be assigned an NAIC Designation **and how a state insurance regulator can require an insurance company to file an otherwise filing exempt structure containing an SCA or related party with the SVO.**

**SUBSIDIARY, CONTROLLED AND AFFILIATED (SCA) ~~AND RELATED PARTY DEBT BOND~~ OR
PREFERRED STOCK INVESTMENTS**

NOTE: See “Policies Applicable to Specific Asset Classes” in Part One for the 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.

Filing Instructions

244. **Common Stock** – An investment in the form of common stock issued by an insurance or non-insurance subsidiary, controlled or affiliated (SCA) entity of the reporting insurance company or an investment in the form of a preferred stock issued by an insurance subsidiary, controlled or affiliated company of the reporting insurance company **is required to be filed with the NAIC Financial Regulatory Services Division** in the manner and form and with the documentation provided for in the Appendix to *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*.
245. **Bonds** – An investment ~~(except for those investments that fit the examples in subclause (i) of detailed in the “SCA and Related Party Filing Exempt Investments” section below)~~, in the form of a bond (i) issued by an insurance or noninsurance SCA entity or related party of the reporting insurance company or (ii) issued as part of a structure which would, pursuant to paragraph 4.a. of SSAP No. 43 – Loan-Backed and Structured Securities, qualify as a related party investment due to the reporting insurance company having credit risk exposure to the SCA or related party (“SCA and related party bond”), is filed with the SVO. To file an SCA and related party bond investment, the reporting insurance company files an Audited Financial Statement for the subsidiary, a copy of the corporate resolution authorizing the issuance of the debt, written evidence that the transaction has been approved by the state of domicile or that no such approval is necessary and, if the subsidiary is an insurance company, the subsidiary’s most recent NAIC Financial Statement Blank, together with the reporting insurance company’s NAIC Financial Statement Blank, internal investment committee memorandum for the investment and loan documentation appropriate to the transaction.
246. **Preferred Stock** – An investment ~~(except for those investments that fit the examples in subclause (i) of the “SCA and Related Party Filing Exempt Investments” section below)~~, in the form of a preferred stock (i) issued by a noninsurance SCA entity or related party of the reporting insurance company or (ii) issued as part of a structure which would, pursuant to paragraph 4.a. of SSAP No. 43 – Loan-Backed and Structured Securities, qualify as a related party investment due to the reporting insurance company having credit risk exposure to the SCA or related party (“SCA and related party preferred stock”), is filed with the SVO. To file an SCA and related party preferred stock issued by a non-insurer, the reporting insurance company files an Audited Financial Statement for the issuer of the preferred stock, a copy of the corporate resolution authorizing the issuance of the preferred stock, written evidence that the transaction has been approved by the state of domicile or that no such approval is necessary, together with details of the terms of the preferred stock, as well as the NAIC Financial Statement Blank for the reporting insurance company.

NOTE: Please see the section on preferred stock in this Part for additional analytical procedures applicable to that asset class.

247. SCA and Related Party Filing Exempt Investments – Certain investments might contain SCA or related party relationships without any credit risk exposure to such SCAs or related parties. For example, an investment could be (i) issued by an SCA or related party special purpose entity (SPE) which itself is not an obligor or party to whom the insurance reporting entity has credit exposure, or (ii) issued as part of a structure in which the originator, sponsor, manager, servicer, other influential transaction party, is an affiliate or related party of the reporting insurance company but the underlying investments do not have credit risk exposure to affiliates or related parties of the insurer. Such investments are eligible for filing exemption unless otherwise ineligible pursuant to guidance in this Manual unrelated to SCA or related party status. However, such investments may be in scope of *SSAP No. 25—Affiliates and Other Related Parties* and subject to reporting as an affiliate or related party transaction in the appropriate investment schedules. For the avoidance of doubt, nothing in this section prohibits a state insurance regulator, in accordance with Part One of this Manual, from requiring its domiciled insurance company to file an otherwise filing exempt investment with the SVO for analysis and/or assignment of an NAIC Designation, thereby making it ineligible for future filing exemption.

Purpose

248. This section applies to credit assessment of any SCA and related party investment in the form of a debt instrument purchased (or otherwise acquired) from an insurance or non-insurance entity (SCA and related party debt bond) and preferred stock issued by an insurance or non-insurance entity (SCA and related party preferred stock) where the insurer has credit risk exposure to the SCA or related party. This procedure is used to determine whether an SCA and related party debt bond or SCA and related party preferred transaction is eligible for reporting as an Investment Security pursuant to this Manual. The determination of “Investment Security” and credit assessment provided by the SVO shall not be construed to reflect assessments specific to affiliated transactions contained in *SSAP No. 25—Affiliates and Other Related Parties*. As such, an SVO-assigned NAIC Designation for affiliated and related party transactions:

- Does not reflect collectability based on independent payment ability of a parent reporting entity.
- Does not reflect whether the transaction was conducted at arm’s-length.
- Does not reflect whether the transaction is considered “economic” under *SSAP No. 25*.

Notification Procedure

249. Prior to applying the procedures required below, the SVO shall:

- Confirm that the SCA relationship has been reported to the NAIC Financial Reporting Services Division, if required.
- If the SCA common and preferred stock transaction was reported (or if not required to be reported), the SVO shall:
 - Inform the state insurance department of the reporting insurance company’s state of domicile that the SCA debt bond or ~~SCA~~-preferred stock has been filed with the SVO.

- Evaluate whether the SCA ~~debt bond~~ or ~~SCA~~ preferred stock transaction is circular within the meaning of that phrase as discussed in this Manual.
- In the case of SCA preferred stock, determine the SCA preferred stock issuer's senior unsecured debt designation and obtain the appropriate designation level for the preferred stock by applying the methodology specified in this Manual.

250. Although an NAIC Designation does not provide assurances regarding arm's-length or economic, if the SVO becomes aware of any information that indicates further review is warranted, the SVO shall contact the reporting entity to discuss, with subsequent notification (by the reporting entity or SVO) to the domiciliary state regulator, as needed. Pursuant to SSAP No. 25, affiliate transactions that are not arm's-length and/or economic are subject to additional accounting and reporting guidelines and each reporting entity is required to be knowledgeable about its domiciliary state regulatory requirements for approval of these transactions.

Definitions

251. The following definitions/concepts are from SSAP No. 25:

- **Arm's-Length** – An arm's-length transaction is defined as a transaction in which willing parties—each being reasonably aware of all relevant facts and neither under compulsion to buy, sell or loan—would be willing to participate.
- **Economic** – An economic transaction is defined as an arm's-length transaction which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof; i.e., “permanence.” The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. An economic transaction must represent a bona fide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance, not the form of the transaction.

Procedure for Credit Assessment of Filed SCA Transaction

252. The procedure specified in this section applies to bonds and preferred stock whose terms, structure, complexity and purpose are like those in transactions between unaffiliated parties filed with the SVO so that credit risk assessment methodologies applied to transactions between unaffiliated parties can be meaningfully applied to transactions between affiliated parties.
253. A determination that a bond or a preferred stock submitted for an assessment under this section is not like a transaction between unaffiliated parties and/or that analytical methodologies applied to transactions between unaffiliated parties cannot be meaningfully applied to the filed transaction shall be in the sole discretion of the SVO.

254. An insurer apprised of the SVO's determination may request a conference call with the SVO to evaluate whether focused disclosure and documentation pertaining to the terms, structure, complexity and purpose of the transaction may enable the SVO to develop a credit assessment methodology specific to the transaction. If the insurer and the SVO agree that a transaction specific credit assessment approach can be developed, administrative details pertaining to the conduct of the assessment shall be as negotiated between the SVO and the insurer.
255. Instead of filing a transaction under this section, an insurer may choose to file an RTAS submission (discussed in this Manual) to solicit an opinion and rationale from the SVO whether or not an SCA and related party transaction would be considered to be like those between unaffiliated entities or ask its domiciliary state regulator to consider requesting that the SVO assist the department in the determination of an NAIC Designation for the transaction under the Regulatory Transactions procedure discussed in this Manual.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-10-20 - Interim Meeting/03-Related Parties/2022-008.04_VOSTF_Amend_SVO_RelatedParties_v5.docx



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

FROM: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau
Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

RE: Clarify the Definition of an NAIC Designation in Parts One and Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*

DATE: September 30, 2022

Summary: As noted in Part One of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual), NAIC Designations and NAIC Designation Categories serve many purposes. NAIC Designations and other Securities Valuation Office (SVO) and Structured Security group (SSG) (collectively, the Investment Analysis Office (IAO)) products are standards identified in the NAIC Policy Statement and Financial Regulation Standards (SFRS) that states, as participants in the Accreditation Program administered by the Financial Regulation Standards and Accreditation (F) Committee, have incorporated into law. Part A of the SFRS identifies laws and regulations deemed necessary to financial solvency regulation, which includes, directly or indirectly, the analytical products of the IAO. These standards include the following:

- Standard 5 requires that insurer-owned securities be assessed in accordance with the standards promulgated by the NAIC IAO.
- Standard 2 refers to the NAIC Risk-Based Capital (RBC) for Insurers Model Act (#312) which assigns RBC factors for securities based on their credit risk as quantified by NAIC Designations.
- Standard 3 refers to the NAIC Accounting Practices and Procedures Manual, which uses NAIC Designations produced by the SVO and/or Price Grids produced by the SSG for statutory accounting purposes including to identify the valuation rules that apply to an investment.
- Standard 8 refers to state investment regulations which often incorporate NAIC model law provisions that relate asset allocations to credit quality or credit risk quantified by NAIC Designations.

- Standard 10 refers to the NAIC Credit for Reinsurance Model Law (#785), which refers to insurer-owned securities compiled by the SVO and identified on the List of Investment Securities, and in a separate provision, letters of credits issued by the banks and non-bank financial institutions whose name is placed on the NAIC List of Qualified U.S. Financial Institutions administered by the SVO, as eligible for use as collateral in reinsurance transactions.

These standards have been included in this memorandum to highlight the many ways in which NAIC Designations are used within NAIC guidance for different purposes. These varied uses in regulatory guidance also highlight why NAIC Designations differ from Credit Rating Provider (CRP) ratings. The current definition of an NAIC Designation in the P&P Manual does not clearly associate its use for these purposes and standards. The attached amendment proposes changes in Part One and Part Two of the P&P Manual to clearly articulate that the assignment of an NAIC Designation to a security considers and/or reflects the following:

- The likelihood of timely payment of principal and/or interest, as appropriate.
- The probability of default.
- The appropriateness and consistency of the risk-based capital model factor that will be applied to the security given its level of risk.
- Statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law.

Recommendation: The SVO recommends adoption of this proposed amendment updating the definition of an NAIC Designation in the P&P Manual to clearly link its use in the NAIC Policy Statement and Financial Regulation Standards (SFRS). The proposed text changes to P&P Manual are shown below with additions in red underline, deletions in ~~red strikethrough~~ as it would appear in the 2022 P&P Manual format.

**PART ONE:
POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE**

ABOUT THIS MANUAL

...

Expression of NAIC Standards in State Law and Regulatory Processes

6. NAIC Designations and other SVO and SSG products are standards identified in the NAIC Policy Statement and Financial Regulation Standards (SFRS) that have been incorporated into state law by the States as participants in the Accreditation Program administered by the Financial Regulation Standards and Accreditation (F) Committee. Information about the F Committee and the Accreditation Program can be accessed here: www.naic.org/cmte_f.htm.
7. Part A of the SFRS identifies laws and regulations deemed necessary to financial solvency regulation. Analytical products of the SVO and SSG [sometimes collectively called the Investment Analysis Office (IAO)] are directly or indirectly incorporated into SFRS Part A standards.
 - Standard 5 requires that insurer-owned securities be assessed in accordance with the standards promulgated by the NAIC IAO.
 - Standard 2 refers to the NAIC Risk-Based Capital (RBC) for Insurers Model Act (#312) which assigns RBC factors for securities based on their credit risk as quantified by NAIC Designations.
 - Standard 3 refers to the NAIC Accounting Practices and Procedures Manual, which uses NAIC Designations produced by the SVO and/or Price Grids produced by the SSG for statutory accounting purposes including to identify the valuation rules that apply to an investment.
 - Standard 8 refers to state investment regulations which often incorporate NAIC model law provisions that relate asset allocations to credit quality or credit risk quantified by NAIC Designations.
 - Standard 10 refers to the NAIC Credit for Reinsurance Model Law (#785), which refers to insurer-owned securities compiled by the SVO and identified on the List of Investment Securities, and in a separate provision, letters of credits issued by the banks and non-bank financial institutions whose name is placed on the NAIC List of Qualified U.S. Financial Institutions administered by the SVO, as eligible for use as collateral in reinsurance transactions.

8. NAIC Designations and other analytical products of the SVO and SSG are produced solely for the benefit of NAIC members in their capacity as state insurance department officials for use in the NAIC Financial Regulation Standards and Accreditation Program as described above. To ensure NAIC members have a central source from which to obtain information about insurer-owned securities (including their NAIC Designations) the VOS/TF has identified the AVS+ Products as the depository for information compiled by the SVO in the SVO List of Investment Securities.

...

NAIC Designations

37. The SVO's analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation that is notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations as defined in this Manual describe a credit quality-risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk except when accompanied by the NAIC Designation subscript, described below.

- Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.
- Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.
- The ability of an insurance company to realize payment on a financial obligation can be affected by factors not related to credit risk or by the manner in which the repayment promise has been structured.
- An NAIC Designation reflects the likelihood of timely payment of principal and interest, as appropriate, and the probability of principal and interest payment default.
- An NAIC Designation reflects the appropriateness and consistency of the risk-based capital model factor that will be applied to the security given its level of risk.

- An NAIC Designation must be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS).
- NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk.
- An NAIC Designation must be interpreted by the NAIC member in context of the NAIC Financial Regulation Standards and Accreditation Program, other characteristics of the investment, and the specific financial and regulatory status of the insurance company.

...

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS
APPLICABLE TO THE SVO

PRODUCTION OF NAIC DESIGNATIONS

NAIC DESIGNATIONS

18. NAIC Designations are proprietary symbols of the NAIC. The SVO and sometimes the SSG produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/TF in this Manual. NAIC Designations identify a category or band of credit risk that reflects the likelihood of timely payment of principal and interest, as appropriate, the probability of principal and interest payment default, and the appropriateness and consistency of its use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) including the risk-based capital model factor that will be applied to the security given its level of risk. NAIC Designations are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law. NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer's capital structure, the likelihood of timely payment and risk of payment default. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual.

...

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-10-20 - Interim Meeting/04-Definition of NAIC Designation Part Two/2022-012.01 P&P Definition of NAIC Desig.docx>

MEMORANDUM

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

FROM: Tom Botsko, Chair, Capital Adequacy (E) Task Force and Property and Casualty Risk-Based Capital (E) Working Group
Philip Barlow, Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group and Life Risk-Based Capital (E) Working Group
Steve Drutz, Chair, Health Risk-Based Capital Working Group

DATE: December 8, 2022

RE: Clarification of the Definition of an NAIC Designation in Part One and Part Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) (Dated Sept. 30, 2022) Amendment to Nov. 30, 2022, Comment Letter

Thank you for the opportunity to provide additional feedback on the letter that was provided to this group dated Nov. 30, 2022.

Upon further discussion with the Valuation of Securities (E) Task Force in the last several days, we have a better understanding of the concept it was proposing with the original wording.

Therefore, we will be working together on revised wording for this bullet point that expresses how the Valuation of Securities (E) Task Force works with the Capital Adequacy (E) Task Force, the Life Risk-Based Capital (E) Working Group, the Health Risk-Based Capital (E) Working Group, the Property and Casualty Risk-Based Capital (E) Working Group, and the Risk-Based Capital Investment Risk and Evaluation (E) Working Group to use the designations provided by Valuation of Securities (E) Task Force in the analysis for determining the risk-based capital (RBC) charges.

Thank you for the opportunity to provide input to this exposure. We look forward to discussing this with you and the Task Force at your convenience.

MEMORANDUM

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

FROM: Tom Botsko, Chair, Capital Adequacy (E) Task Force and Property and Casualty Risk-Based Capital (E) Working Group
Philip Barlow, Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group and Life Risk-Based Capital (E) Working Group
Steve Drutz, Chair, Health Risk-Based Capital Working Group

DATE: November 30, 2022

RE: Clarification of the Definition of an NAIC Designation in Part One and Part Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) (Dated Sept. 30, 2022)

Thank you for the opportunity to provide feedback on the update to the exposed definition on the referenced document. Under part 37 of the NAIC designation section, the second added bullet item states the following:

“An NAIC Designation reflects the appropriateness and consistency of the risk-based capital model factor that will be applied to the security given its level of risk.”

We believe that this statement conflicts with the mission and purpose of the Capital Adequacy (E) Task Force, the Life Risk-Based Capital (E) Working Group, the Health Risk-Based Capital (E) Working Group, the Property and Casualty Risk-Based Capital (E) Working Group, and the Risk-Based Capital Investment Risk and Evaluation (E) Working Group. Therefore, we recommend that this bullet point be removed. While the appropriate designation assignment is important, it is the responsibility of the Capital Adequacy (E) Task Force and the supporting risk-based capital (RBC) working groups to determine and recommend the appropriate charge (model factor) in all aspects of the RBC formulas.

In addition, the next to last bullet point of this same section mentions that the NAIC designations do not measure other risks. This further supports the request to remove this proposed item. The Capital Adequacy (E) Task Force and its working groups assess all the risks as appropriate to determine the RBC charge associated with the investment. An investment’s designation may result in a different RBC factor once the specific investment type is analyzed. While an NAIC designation may be used for multiple types of investments, the appropriate RBC charge may vary greatly depending on the analysis, and in particular, because of the type of investment.

Once the Capital Adequacy (E) Task Force is aware of a change or implementation of a new or revised designations, the Task Force and it’s working groups will work with the other working groups or task forces to determine the best approach to evaluate the appropriate RBC charge associated with the assigned designation for a given investment type.

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As you may recall, the Risk-Based Capital Investment Risk and Evaluation (E) Working Group was created to work with the Valuation of Securities (E) Task Force and other groups in parallel to streamline the process of determining and evaluating the appropriate RBC charge for new investment types. As investments are recommended to be reported separately in the annual statement, the Risk-Based Capital Investment Risk and Evaluation (E) Working Group should receive a referral or at least be made aware of the plan to segregate a new investment type for reporting purposes. The Capital Adequacy (E) Task Force and the Risk-Based Capital Investment Risk and Evaluation (E) Working Group need to keep in close communication with these proposals to make sure an appropriate charge is available when the reporting change is implemented. In addition, if the reason for a plan to segregate a specific investment type for reporting purposes is primarily to change the applicable RBC charge, the Risk-Based Capital Investment Risk and Evaluation (E) Working Group should discuss whether this segregation is appropriate prior to any plan to segregate the investment type.

Because the Risk-Based Capital Investment Risk and Evaluation (E) Working Group is relatively new to the Capital Adequacy (E) Task Force, it is imperative that we all communicate our priorities and proposals to improve the process.

As the Risk-Based Capital Investment Risk and Evaluation (E) Working Group takes on its new responsibilities, it will continue to prioritize its tasks, as well as any new proposals.

Thank you for the opportunity to provide input to this exposure. We are happy to discuss this with you and the Task Force at your convenience.



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December 5, 2022

The Valuation of Securities Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Comments, Staff Proposal: “Clarify the Definition of NAIC Designations in...the Purposes and Procedures Manual....”

Dear Ms. Mears and Task Force Members,

This letter supports the concept of clarifying the definition of NAIC Designations. To achieve this the *Purposes and Procedures Manual* needs to be streamlined deleting duplicative language. Markups of the *Manual* with specific recommendations to accomplish this are attached. This letter also recommends approaches for dealing with what have been called “other non-payment risks” and I submit it as an independent consultant and long-time observer of the work of the Valuation of Securities Task Force.

NAIC Designations are Simply Opinions of Credit Risk

The *Manual* defines credit risk in Part One ¶37 as “the relative financial capability of an obligor to make the payments contractually promised to a lender.” I believe this definition is reasonable and comprehensive in that it refers to “payments contractually promised” and nothing else, and this is reflected consistently in many places throughout the *Manual*. The Appendix to this letter shows over two dozen places where Designations are associated with credit risk.

Eliminating Unnecessary Language

The present text effectively defines NAIC Designations in separate three places. Because detailed descriptions for each of the six NAIC Designations appear in Part Two ¶21 – 24 other definitions (in Part One ¶37 and 88-89), are redundant and should be deleted. If additional information is needed to “clarify” the meaning of Designations it could be added to the section where the Designations are explained in detail where readers will naturally seek information about the meaning of Designations.

The *Manual* would also be made more usable by deleting unnecessary language such as Part One ¶6 - 8 which discusses the uses of Designations rather than what they actually are and how the SVO is charged with producing them.

Also in Part One are five bullet points in ¶37 discussing Designations. Rather than adding three more bullets as is proposed I recommend deleting this entire paragraph as each Designation is already discussed in detail in Part Two ¶21 – 24 as noted previously.

“Other Non-Payment Risk”

The references to “other non-payment risk” could be clarified. Given that Designations estimate the probability that a borrower will fulfil its commitments, if there are other reasons for “non-payment” they also need to be addressed explicitly.

Defaults are only one reason a lender may be uncertain about the amount of the payments it will receive. While defaults themselves are incorporated into RBC calculations, lending agreements increasingly contain other optional provisions that could change cash flows. These could be to the advantage, or detriment, of lenders. The question at hand is how to understand and deal with these uncertainties as to amounts due. This is distinctly different from the uncertainty about whether that amount will or will not be paid *i.e.* credit risk.

Possible Approaches

Callable bonds provide a simple an example of where cash flows can be uncertain. For instance, assume a ten-year 5% bond with a five-year call option which means it is subject to early redemption. The five-year call makes it possible that investors may not receive the last five years of interest payments. This uncertainty was well understood by the professionals who developed the RBC formula. It is not problematic, however, because of the standard market convention, then and now, for accounting for callable bonds.

The market convention for callable bonds assumes the lender will receive the worst of all possible outcomes without the default of the borrower. This is known as “yield-to-worst” which “is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting*.” This is why it is possible to ignore the potential adverse impact of the exercise of a call option -- because the worst is already assumed.

Call features are not the only optional provisions that have been incorporated into the contractual promises of bond issues. It is possible to find other provisions embedded into agreements that can increase -- or decrease -- expected payments even though the issuer remains in full compliance with the terms of the borrowing.

Solutions could be found for bonds where there is a lack of certainty concerning the actual dollar amount of cash flows that will be due by using concepts similar to “yield-to-worst”. The accounting and reporting would be relatively simple, “conservative” and most likely effective. It may bring with it some less desirable effects, however, so active discussion and collaboration is necessary. This concept could be implemented by coordinating with the Capital Adequacy Task Force and then SAPWG to develop appropriate reporting procedures.

Another approach would be to treat bonds with embedded options as hybrid securities -- having the characteristics both of debt and non-debt. Unfortunately risk-based capital formulas do not appear to

*<https://www.investopedia.com/terms/y/yieldtoworst.asp#:~:text=Yield%20to%20worst%20is%20a,it%20out%20before%20it%20matures.>

Ms. Mears and Task Force Members

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contemplate such structures presently so in all probability it would require extensive coordination to make this change.

While any possible approach certainly should be discussed at this Task Force along with Capital Adequacy and Statutory Accounting, attempting to layer these risks of option exercise into the existing credit risk structure appears to have relatively little potential. Not only would it be difficult to quantify the added uncertainty by folding these two different risks into Designations but it would also conflate the two and seriously compromise the integrity of Designations. This would make it difficult for them to be used in RBC calculations. Such action should be taken in coordination with the Capital Adequacy Task Force.

Denying that these assets are “bonds” would also be problematic. In fact they are bonds: borrowings with the promise to repay, so they should be classified as such even as work is done to assure reasonable reporting of actual amounts due

Summary

The definition of Designations can be clarified by omitting unnecessary words as shown in the attachment.

Incorporating a “yield to worst” methodology would allow regulators to address the uncertainty in the amount of reported cash flows beyond what is already reflected in measures of credit quality.

A handwritten signature in blue ink, which appears to read "Charles Therriault".

Copies: Charles Therriault and Denise Genao-Rosado

**PART ONE:
POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE**

ABOUT THIS MANUAL

...

Expression of NAIC Standards in State Law and Regulatory Processes

- ~~6. NAIC Designations and other SVO and SSG products are standards identified in the NAIC Policy Statement and Financial Regulation Standards (SFRS) that have been incorporated into state law by the States as participants in the Accreditation Program administered by the Financial Regulation Standards and Accreditation (F) Committee. Information about the F Committee and the Accreditation Program can be accessed here: www.naic.org/cmte-f.htm.~~
- ~~7. Part A of the SFRS identifies laws and regulations deemed necessary to financial solvency regulation. Analytical products of the SVO and SSG [sometimes collectively called the Investment Analysis Office (IAO)] are directly or indirectly incorporated into SFRS Part A standards.~~
 - ~~▪ Standard 5 requires that insurer-owned securities be assessed in accordance with the standards promulgated by the NAIC IAO.~~
 - ~~▪ Standard 2 refers to the NAIC Risk-Based Capital (RBC) for which assigns RBC factors for securities based on their credit risk as quantified by NAIC Designations.~~
 - ~~▪ Standard 3 refers to the NAIC Accounting Practices and Procedures Manual, which uses NAIC Designations produced by the SVO and/or Price Grids produced by the SSG for statutory accounting purposes including to identify the valuation rules that apply to an investment.~~
 - ~~▪ Standard 8 refers to state investment regulations which often incorporate NAIC model law provisions that relate asset allocations to credit quality or credit risk quantified by NAIC Designations.~~
 - ~~▪ Standard 10 refers to the NAIC Credit for Reinsurance Model Law (#785), which refers to insurer-owned securities compiled by the SVO and identified on the List of Investment Securities, and in a separate provision, letters of credits issued by the banks and non-bank financial institutions whose name is placed on the NAIC List of Qualified U.S. Financial Institutions administered by the SVO, as eligible for use as collateral in reinsurance transactions.~~

8—NAIC Designations and other analytical products of the SVO and SSG are produced solely for the benefit of NAIC members in their capacity as state insurance department officials for use in the NAIC Financial Regulation Standards and Accreditation Program as described above. To ensure NAIC members have a central source from which to obtain information about insurer-owned securities (including their NAIC Designations) the VOS/TF has identified the AVS+ Products as the depository for information compiled by the SVO in the SVO List of Investment Securities

NAIC Designations

37. The SVO's analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation that is notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations as defined in this Manual describe a credit quality risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk except when accompanied by the NAIC Designation subscript, described below:

- Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.
- Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.
- The ability of an insurance company to realize payment on a financial obligation can be affected by factors not related to credit risk or by the manner in which the repayment promise has been structured.
- An NAIC Designation reflects the likelihood of timely payment of principal and interest, as appropriate, and the probability of principal and interest payment default.
- An NAIC Designation reflects the appropriateness and consistency of the risk-based capital model factor that will be applied to the security given its level of risk.
- An NAIC Designation must be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS).

- ~~NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk.~~
- ~~An NAIC Designation must be interpreted by the NAIC member in context of the NAIC Financial Regulation Standards and Accreditation Program, other characteristics of the investment, and the specific financial and regulatory status of the insurance company.~~

Definitions

88. ~~**NAIC Designation**~~ Means any one of the gradations of credit quality and credit risk identified by the ~~NAIC 1~~ through ~~NAIC 6~~ symbols ~~further discussed and~~ defined in this Manual and may reflect notching pursuant to one or both of the notching procedures discussed in this Manual. ~~NAIC Designations are proprietary symbols of the NAIC to be used by the SVO and SSG or under certain circumstances by an insurer to denote a category or band of credit risk.~~
89. ~~**NAIC Designation Category**~~ Means and refers to 20 more granular delineations of credit risk in the ~~NAIC 1~~ through ~~NAIC 6~~ credit risk scale used by the VOS/TF to relate credit risk in insurer-owned securities to a risk-based capital factor assigned by the NAIC Capital Adequacy (E) Task Force. Each delineation of credit risk is represented by a letter (a Modifier) which modifies the NAIC Designation grade to indicate a more granular measure of credit risk within the NAIC Designation grade. The more granular delineations of credit risk are distributed as follows: 7 for the ~~NAIC 1~~ Designation grade indicated by the letters A through G; 3 delineations each for each of the NAIC Designation grades ~~NAIC 2, NAIC 3, NAIC 4~~ and ~~NAIC 5~~ indicated by the letters A, B and C and 1 delineation for NAIC Designation grade ~~NAIC 6~~. The NAIC Designation Category framework is shown in this Manual. All Modifiers roll up into the respective NAIC Designation grade as they are a subset of them.

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS
APPLICABLE TO THE SVO

PRODUCTION OF NAIC DESIGNATIONS

NAIC DESIGNATIONS

18. NAIC Designations are proprietary symbols of the NAIC. The SVO and sometimes the SSG produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/TF in this Manual. NAIC Designations are measures of the credit risk which is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. ~~of individual debt instruments concerning the identify a category or band of credit risk that reflects the likelihood of timely payment of principal and interest, as appropriate, the probability of principal and interest payment default, and the appropriateness and consistency of its use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) including the risk-based capital model factor that will be applied to the security given its level of risk.~~ NAIC Designations are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law. NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer's capital structure, the likelihood of timely payment and risk of payment default. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual.
19. **NAIC 1** is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer's credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An **NAIC 1** obligation should be eligible for the most favorable treatment provided under the NAIC Financial Regulation Standards and Accreditation Program.
20. **NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An **NAIC 2** obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

21. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
22. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.
23. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.
24. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.

APPENDIX

Throughout the P&P Manual there are numerous and consistent descriptions showing that the SVO is charged with assessing credit risk which is defined in Part One, ¶ 37 as “the relative financial capability of an obligor to make the payments contractually promised to a lender.”

Here are over two dozen examples of that:

P1 29 “The NAIC, therefore, rejects the view that insurance company representatives may reasonably rely on **SVO credit assessments**”

P1 32 “This process is distinct from the **SVO's assessment of an investment's credit risk**, which results in a NAIC Designation”

P 1 34 “Because **SVO analytical determinations of credit quality** do not convey opinions, conclusions or informational content relative to statutory accounting status, the SVO may assign an NAIC Designation....”

P1 36 “ The SVO shall conduct the following ongoing operations:
Analysis of credit risk for purposes of assigning an NAIC Designation....”

P1 38 “37. The SVO's analysis of credit risk (**hereafter defined**), is expressed as an opinion of credit quality by assignment of an NAIC Designation that is notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations as defined in this Manual describe a credit quality-risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk except when accompanied by the NAIC Designation subscript, described below.

- **Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.**

P1 38 38. The result of the SVO's credit analysis, expressed as **an opinion of credit quality** by assignment of an NAIC Designation shall be further expanded into NAIC Designation Categories as, and for the purposes, discussed in this Manual

P1 Note Prior to 57 “NOTE: See "Policies Applicable to the Filing Exemption (FE) Process" below; "NAIC Policy on the Use of **Credit Ratings of NRSROs**”

P1 82 “and “**Use of Credit Ratings of NRSROs In NAIC Processes**” and “Definition - Credit Ratings Eligible for Translation to NAIC Designations”

P1 85 “85. NAIC Designation is Capped to Highest NAIC CRP Rating -The SVO shall not assign an NAIC Designation for a security that has a credit rating assigned by an NAIC CRP when the **NAIC Designation would express an opinion of credit** quality higher than that indicated by the rating assigned by the NAIC CRP, except...”

Definitions

88. NAIC Designation - Means any one of the **gradations of credit quality and credit risk** identified by the NAIC 1 through NAIC 6 symbols further discussed and defined in this Manual and may reflect notching pursuant to one or both of the notching procedures discussed in this Manual. NAIC Designations are proprietary symbols of the NAIC to be used by the SVO and SSG or under certain circumstances by an insurer to denote a category or band of credit risk.

89. NAIC Designation Category - Means and refers to 20 more granular delineations of **credit risk** in the NAIC 1 through NAIC 6 credit risk scale used by the VOS/TF to relate credit risk in insurer-owned securities to a risk-based capital factor assigned by the NAIC Capital Adequacy (E) Task Force. Each delineation of credit risk is represented by a letter (a Modifier) which modifies the NAIC Designation grade to indicate a more granular measure of credit risk within the NAIC Designation grade. The more granular delineations of credit risk are distributed as follows: 7 for the NAIC 1 Designation grade indicated by the letters A through G; 3 delineations each for each of the NAIC Designation grades NAIC 2, NAIC 3, NAIC 4 and NAIC 5 indicated by the letters A, B and C and 1 delineation for NAIC Designation grade NAIC 6. The NAIC Designation Category framework is shown in this Manual. All Modifiers roll up into the respective NAIC Designation grade as they are a subset of them.

Part Two

18. NAIC Designations are proprietary symbols of the NAIC. The SVO and sometimes the SSG produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/TF in this Manual. **NAIC Designations identify a category or band of credit risk.** NAIC Designations are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law. NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual.

19. **NAIC 1 is assigned to obligations exhibiting the highest quality. Credit risk** is at its lowest and the issuer's credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An NAIC 1 obligation should be eligible for the most favorable treatment provided under the NAIC Financial Regulation Standards and Accreditation Program

20. **NAIC 2 is assigned to obligations of high quality. Credit risk** is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An NAIC 2 obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

21. **NAIC 3 is assigned to obligations of medium quality. Credit risk** is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is

reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An NAIC 3 obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program

22. NAIC 4 is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An NAIC 4 obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

23. NAIC 5 is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An NAIC 5 Designation suggests a very high probability of default. An NAIC 5 obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

24. NAIC 6 is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An NAIC 6 obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program

29. Securities with NAIC SGI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC SGI Designation incurs the regulatory treatment associated with an NAIC 5 Designation

31. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation.

36. The SVO shall conduct the following ongoing operations:

- Analysis of credit risk for purposes of assigning an NAIC Designation.
- Identification and analysis of securities that contain other non-payment risk and communication of this information by assignment of the NAIC Designation subscript to such securities.

42. Illustration - The distinctions in credit risk made in the notching process involve (conceptually) the issuer's actual capital structure. The hypothetical capital structure below is shown to illustrate and explain notching:

Senior secured	Notch up from the benchmark
Senior unsecured	Benchmark NAIC Designation
Senior subordinated	Notch down from the benchmark
Junior subordinated	Notch down from benchmark
Preferred stock	Notch down from benchmark

97. For purposes of this section, probable regulatory treatment means the professional opinion of the SVO as to the credit quality designation

143. Listing a Counterparty-An insurance company that wants to have a counterparty listed on the List of Counterparties Rated by the SVO for Schedule DB, Part D, Section 1 shall submit to the SVO:...

...Evidence of an NAIC CRP counterparty rating, an NAIC CRP senior unsecured rating or a copy of the most recent Audited Financial Statement for the counterparty, or the counterparty's guarantor, so that the SVO can assess credit quality and assign an NAIC Designation

155. An NRSRO that wishes to provide Credit Rating Services to the NAIC may indicate its interest by sending a letter to the Chair of the VOS/TF with a copy to the Director of the SVO, in which it:...

- ...Provides a chart relating its credit rating symbols to NAIC Designations.

Part Three

46. The following terms have the meaning shown below:

- Credit Substitution Methodology - Refers to an analytical technique in which an NAIC Designation is assigned to a security on the basis of the credit strength of a third party

279. Credit Risk Assessment - A calculation of the credit risk of a fund's underlying investment portfolio using a weighted average rating factor methodology (WARF)....

NAIC Fund Methodology*

287. The SVO shall:

- Conduct a look-through assessment
- Conduct a credit-risk assessment to determine the credit risk of the fund's cash flows.
- Conduct a speculative characteristics analysis.
- Determine whether the fund's cash flow can or cannot be appropriately characterized as fixed income like for regulatory purposes.
- If the SVO determines that the fund's cash flow can be appropriately characterized as fixed income for regulatory purposes, it assigns an NAIC Designation to reflect the credit risk associated with the fund's cash flow and includes the name of the fund on the appropriate NAIC List.**

** NOTE: The NAIC Designation does not address the fund's ability to meet payment obligations because the insurer/ shareholder does not own the bonds in the portfolio; the NAIC Designation instead conveys the credit risk/ quality of the fixed income like cash flow generated by the ETF.



Mike Monahan
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December 5, 2022

Ms. Carrie Mears, Chair
Valuation of Securities Task Force
National Association of Insurance Commissioners
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office
(the “P&P Manual”) to Clarify the Definition of an NAIC Designation in Part One and Part Two

Dear Ms. Mears,

The undersigned (ACLI, PPIA, and NASVA) appreciate the opportunity to comment on the exposure referred to above that was released for comment by the Valuation of Securities Task Force (VOSTF) on October 20, 2022.

The undersigned generally like to provide constructive comments surrounding VOSTF exposures (and NAIC exposures more generally). We consistently ask ourselves the following questions:

- 1) What objective(s) are the proposed changes trying to achieve?
- 2) Do the proposed changes achieve the objective(s) and/or are they appropriate?
- 3) If the proposed changes do not achieve the objective, or are not appropriate, what constructive comments can we provide?

American Council of Life Insurers | 101 Constitution Ave, NW, Suite 700 | Washington, DC 20001-2133

The American Council of Life Insurers (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

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PPIA is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PPIA serves 63 member companies and works with regulators, NASVA, the American College of Investors Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace.

NASVA is an association of insurance company representatives who interact with the NAIC Securities Valuation Office (“SVO”) to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes.

Our comments will be provided through this lens for both Part One Proposed Changes and Part Two Proposed Changes.

Part One Proposed Changes

The proposed changes to Part One of the P&P Manual can appear benign, but the objective is unclear. The following provides some thoughts for which VOSTF members may want to consider prior to adopting.

As previously noted by industry, regulators and the SVO, the P&P Manual can be at times difficult to follow and interpret. Industry believes that are three reasons, in part, that contribute to this difficulty:

- 1) The objectives of proposed changes included within exposures are at times themselves not sufficiently clear and/or the practical considerations only becomes known at some later date through subsequent interpretation.
- 2) Over time, changes to the P&P Manual are made that are incremental without fully considering what is said in other parts.
- 3) There are ambiguities and inconsistencies between parts, or even within parts, which make understanding the P&P Manual challenging and open to interpretation.

The proposed changes to Part One have an overriding objective to “Clarify the Definition of an NAIC Designation” and includes the following proposed changes to paragraph 37, in Part One of the P&P Manual, which defines what an NAIC designation represents:

- 1) An NAIC Designation reflects the likelihood of timely payment of principal and interest, as appropriate, and the probability of principal and interest payment default.
- 2) An NAIC Designation reflects the appropriateness and consistency of the risk-based capital model factor that will be applied to the security given its level of risk.
- 3) An NAIC Designation must be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS).

Theoretically, the proposed changes could be hard to argue against (e.g., NAIC designations should be consistent with the risk-based model factors). However, the proposed changes may be more aspirational and not achieve the objective of trying to “Clarify the Definition of an NAIC Designation.”

For example, it is our understanding the risk-based capital factors were developed using Moody’s historic corporate bond default and loss given default data. If the first two proposed changes are added to what an NAIC Designation represents, will this provide additional clarity or just raise additional questions?

More specifically, if NAIC designations represent “probability of default” while the risk-based capital factors “represent both probability of default and the loss given a default” – are NAIC Designations and risk-based capital factors, by definition, inconsistent? Does this provide additional clarity or just raise further potential inconsistencies?

What practical considerations do the proposed changes have?

- 1) Do the NAIC risk-based capital factors need to be changed to be consistent with the definition of an NAIC Designation?

Our understanding, from recent discussions with the majority of rating agencies, is that they all essentially utilize a blended probability of default/loss given default methodology for rating bonds – e.g., more of a probability of default for investment grade securities, with a shift in direction toward factoring in loss given default for securities at the lower end of investment grade or below investment grade, although the specifics depend upon rating agency, type of security, and situational context.

- 2) Does this mean that some, part, or all of rating agencies' ratings, upon which NAIC Designations are based, are not consistent with the risk-based capital factors – i.e., NAIC designations need to change to be consistent with the NAIC risk-based capital factors?

It is our understanding that not only are the risk-based capital factors based on both probability of default and the loss given a default, but they are also based on the universe of public bonds rated by Moody's.

- 3) Does this mean that only NAIC Designations based upon Moody's ratings, or SVO evaluations utilizing a methodology consistent with Moody's methodology, consistent with the NAIC risk-based capital factors?

Prior to adopting this language, we urge the VOSTF to carefully think through these questions, including any practical considerations related to an NAIC Designation being in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS). If the proposed changes are deemed appropriate, and the VOSTF members want to adopt them, industry has only two asks.

One, the first proposed change would need to include the shaded language to 1) be consistent with paragraph 35 (included in Part Two of the P&P Manual and discussed below) and 2) not be inconsistent with the second last bullet of paragraph 37 related to liquidity and deferrals.

An NAIC Designation reflects the likelihood of timely payment of principal and interest (as defined in the contractual debt documents), as appropriate, and the probability of principal and interest payment default.

Two, share with industry any further objective(s), including any practical considerations or implications of the proposed changes, so industry is not surprised of their impact via a subsequent interpretation.

Part Two Proposed Changes

The other proposed change relates to Part Two of the P&P Manual entitled, "Operational and Administrative Instructions Applicable to the SVO," the first paragraph (paragraph 18) of the "Production of NAIC Designations" section. The whole of that section is included as an Attachment to this letter as we will be referring to specific paragraphs. The proposed changes to paragraph 18 are included below:

18. NAIC Designations are proprietary symbols of the NAIC. The SVO and sometimes the SSG produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/TF in this Manual. NAIC Designations identify a category or band of credit risk that reflects the likelihood of timely payment of principal and interest, as appropriate, the probability of principal and interest payment default, and the appropriateness and consistency of its use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) including the risk-based capital model factor that will be applied to the security given its level of risk. NAIC Designations are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law. NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer's capital structure, the likelihood of timely payment and risk of payment default. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual.

Unlike the proposed changes to Part One, which are related to the definition of an NAIC Designation, this section relates to “Operational and Administrative Instructions Applicable to the SVO.”

No rationale was provided as to the objective for these changes. However, the section suggests the proposed changes relate to operational and/or administrative changes applicable to the SVO.

Currently, industry understands there are two instances for which notching is appropriate in the P&P Manual – 1) “position of a specific security in the issuer’s capital structure” and 2) “non-payment risk” related to Subscript S securities. Both instances are mentioned in paragraph 18 above, and each more fully explained in the section attached to this letter.

Industry understands these notching procedures are applied to securities that are not filing exempt. The SVO, not unlike how rating agencies apply their rating methodologies, designates the issuer and adjusts the designation for where the specific security is within the capital structure. In paragraph 39, notching for Subscript S is utilized “routinely, for any security or financial product filed with the SVO.”

Currently, it appears the SVO makes limited use of Subscript S notching as evidenced by relatively few Subscript S designations as described in paragraph 38 of the attachment. However, the SVO is concurrently looking to expand the definition of Subscript S securities in ways that conflict with the definition of an NAIC designation, as highlighted in our letter of September 12, 2022, while also suggesting it applies to filing exempt securities. However, the proposed changes now add a third instance for notching: 3) “likelihood of timely payment and risk of payment default.” There is no further objective of explanation for this third instance.

Close examination of the P&P Manual language related to Subscript S securities (i.e., paragraph 39) suggests it does not apply to filing exempt securities. If this interpretation is incorrect, the addition of the proposed language, which is a third instance of notching in the highlighted portion of the paragraph above, would then seem to suggest notching itself applies to all securities that are filing exempt and raises the question of whether all securities need to be filed with the SVO (i.e., essentially all securities have to be adjusted for where they are within the capital structure by the SVO (as are

already done so by rating agencies) and for which the SVO wants to notch due to not meeting the “likelihood of timely payment and risk of default” (see also our comments related to similar but not identical language under Part One above that also needs adjustment in that context)).

The SVO has not been able to explain to industry which populations of securities are subject to notching – filing exempt securities, filed securities, neither, or both. Combined with other recent and concurring exposures, such as the proposed expansion of securities meeting the definition of Subscript S, and the lack of insight into the overall rationale and objectives of this part of the VOSTF exposure, industry is challenged to fully react to and provide constructive comments due to our lack of understanding of what the practical implications and considerations are. Therefore, with regards to the proposed changes to Part Two, we ask the VOSTF to help industry understand such objectives and practical implications.

In summary, we are uncertain as to the actual objectives and the likely downstream effects, and do not want to be surprised by their impact upon any future subsequent interpretation.

We stand ready to work collaboratively with the Task Force and SVO on this and other matters in the future.

Sincerely,



Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey
Tracey Lindsey
NASVA

John Petchler
John Petchler
on behalf of PPIA
Board of Director

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Production of NAIC Designations

PRODUCTION OF NAIC DESIGNATIONS

NAIC DESIGNATIONS

18. NAIC Designations are proprietary symbols of the NAIC. The SVO and sometimes the SSG produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/TF in this Manual. NAIC Designations identify a category or band of credit risk. NAIC Designations are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law. NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual.
19. **NAIC 1** is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer's credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An **NAIC 1** obligation should be eligible for the most favorable treatment provided under the NAIC Financial Regulation Standards and Accreditation Program.
20. **NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An **NAIC 2** obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
21. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

22. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.
23. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.
24. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.

NOTE: See "NAIC Designations," "Prohibition on Use of NAIC Designation in a Covenant" and "Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force" in Part One; "NAIC Designation Categories" below; and "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three.

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Production of NAIC Designations

NAIC DESIGNATION CATEGORIES

25. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories, as described and defined in this Manual.
26. NAIC Designation Categories are a subset of NAIC Designations and are used by the VOS/TF to link the NAIC risk-based-capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
1		A		1.A
1		B		1.B
1		C		1.C
1		D		1.D
1		E		1.E
1		F		1.F
1		G		1.G
2		A		2.A
2		B		2.B
2		C		2.C
3		A		3.A
3		B		3.B
3		C		3.C
4		A		4.A
4		B		4.B
4		C		4.C
5		A		5.A
5		B		5.B
5		C		5.C
6				6

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION

27. An insurance company that self-assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.
28. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met.
29. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation.
30. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.
31. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.
32. Securities that are residual tranches or interests, as defined in *SSAP 43R – Loan Backed and Structured Securities*, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.

NOTE REGARDING RESIDUAL TRANCHES OR INTERESTS: For 2021 year-end reporting only, residual tranches or interests previously reported on Schedule D-1: Long-Term Bonds shall be permitted to be reported on Schedule D-1 with an NAIC 6* Designation, however an NAIC 5GI is not permitted.

NOTE: The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.

NAIC DESIGNATION SUBSCRIPT S

Description of Other Non-Payment Risk

33. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.
34. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.
35. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a schedules basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).
36. Using the broad concepts identified above, non-payment risk may be present when:
 - A reporting insurance company takes on a participatory risk in the transaction;
 - *Illustration* – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.
 - The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;

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- *Illustration* – A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.
 - *Illustration* – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity dates (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.
37. Agrees to an exposure that has the potential to result in a significant delay in payment of contractually promised interest and/or a return of principal in an amount less than the original investment.

Meaning of the Subscript S Symbol

38. An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows: **NAIC 2S**.
39. The SVO shall assess securities for other non-payment risk:
- Routinely, for any security or financial product filed with the SVO.
 - As part of the analysis of a security or financial product submitted to the SVO under the RTAS – Emerging Investment Vehicle process discussed in of this Manual.
 - When requested to do so by any state insurance regulator acting pursuant to this Manual, and:
 - When requested by the VOS/TF; or
 - In support of any other NAIC group engaged in the analysis of investment risks in new securities.

NOTE: See “NAIC Designation Subscript S” in Part One.

SVO NOTCHING GUIDELINES

Definition and Purpose

40. Notching is defined as the process used to make distinctions between different liabilities in an issuer capital structure to reflect differences in credit or other non-payment risk smaller than a whole grade. Notching expresses differences in expected loss (i.e., severity) of an issuer's liabilities by their relative priority of claim in bankruptcy.
41. With the exception of **NAIC 6**, notching distinctions are expressed by combining an NAIC Designation with an NAIC Designation Modifier to produce an NAIC Designation Category. For example, as shown in the table above, **NAIC 1** is combined with NAIC Designation Modifier 1.A to produce the NAIC Designation Category 1.A. Modifiers are used with or assigned to the **NAIC 6** Designation.

Notching NAIC Designation Categories (to Reflect Credit Risk)

42. **Illustration** – The distinctions in credit risk made in the notching process involve (conceptually) the issuer's actual capital structure. The hypothetical capital structure below is shown to illustrate and explain notching:

Senior secured	Notch up from the benchmark
Senior unsecured	Benchmark NAIC Designation
Senior subordinated	Notch down from the benchmark
Junior subordinated	Notch down from benchmark
Preferred stock	Notch down from benchmark

Methodology

43. The SVO determines the benchmark NAIC Designation Category for the senior unsecured obligation of the issuer or its equivalent. The SVO adjusts the benchmark NAIC Designation Category up or down to reflect the difference in risk between the benchmark security and the specific liability under review by the SVO.

SVO Guidelines for Notching

44. The SVO shall notch an NAIC Designation Category for an issuer up or down to reflect the position of a specific liability in the issuer's capital structure.

45. Notching upward from a benchmark NAIC Designation Category is almost exclusively associated with transactions in which the SVO determines that collateral act to further reduce the probability of default from that implied by the issuer's senior unsecured NAIC Designation Category.
46. In determining the number of notches that should be applied to a security, the SVO shall apply the following guidelines.

Notching Investment Grade Issuers

47. Notching for issuer's whose senior unsecured benchmark NAIC Designation is **NAIC 1** and **NAIC 2** is therefore based on the following general guidelines:
 - **Secured debt** may be designated one notch above the senior unsecured issuer designation.
 - **Subordinated debt** (including junior and senior subordinated) are generally designated one notch below the senior unsecured rating.
 - **Preferred debt** will generally be designated one notch below subordinated debt (two below senior unsecured or senior implied).
 - **Holding company debt** is generally designated at or below the lowest rated debt security that would be assigned at the principal operating company.

Notching for Non-Investment Grade Issuers

48. Given the risks associated with non-investment grade issues, notching for issuer's whose senior unsecured benchmark NAIC Designation is **NAIC 3**, **NAIC 4** and **NAIC 5** requires grater professional judgment and discretion.
49. As such, notching differentials for issuers with **NAIC 3**, **NAIC 4** and **NAIC 5** Designations may be wider than for issuer's whose senior unsecured NAIC Designation is **NAIC 1** or **NAIC 2**.

Notching for NAIC Designation Subscript (to Reflect Non-Payment Risk Unrelated to Credit Risk)

50. **Grant of Significant Discretion** – The SVO is granted significant discretion to determine the number of notches it will assign to a security to reflect other non-payment risk. This discretion is to be exercised in the context of the regulatory objective and purpose of this procedure. SVO determinations made under this subparagraph are subject to review in accordance with the procedures described of this Part, above.

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SVO Notching Guidelines

Relevant Considerations

51. The name given to the security is not relevant to a determination whether this subparagraph should be applied. The relevant criterion is whether the risks in the security are clearly credit risks or whether they are not clearly credit risks.
52. Factors the SVO may deem relevant to the question of notching for other non-payment risk may include:
 - Any security or financial instrument denominated with a term associated with fixed income investments must contain a clearly stated obligation to pay a return and to repay the amount of the principal repayment. Otherwise it is not rational or possible to assign an NAIC Designation.
 - Any security or financial instrument denominated as fixed income that does not contain a legally binding obligation to pay shall not be assigned an NAIC Designation and instead will be reported to the VOS/TF and the Chief Examiner of the State of Domicile.
 - Any security or financial instrument that is denominated as fixed income and that contains a promise to pay that is otherwise conditional may be notched either under this subparagraph to reflect other non-payment risks or under the notching procedure for credit risk to reflect the expected loss of that obligation in the issuer's specific capital structure, depending on which approach seems more appropriate to the SVO.
53. The widest degree of notching for a security or financial instrument is likely to be for a security that is denominated as fixed income, but which is deemed to be a perpetual investment and to not require payment of dividends.
54. In contracts that permit the issuer flexibility to not make payments, the SVO would focus on the degree of financial discretion afforded the issuer to not make payments and the circumstances under which that financial flexibility will be exercised.
55. In contracts where the insurer agrees to accept a risk or participate in an activity that may reduce either the interest or dividend otherwise agreed on or the amount to be repaid to less than the original principal investment, the SVO would consider whether the risk of a loss is structurally or otherwise mitigated.
56. Notching differentials are expected to be wider for **NAIC 3**, **NAIC 4** and **NAIC 5** issuers because the issuer's credit risk is deemed to increase the likelihood that the issuer will avail itself of contractually provided flexibility to not pay or increase the likelihood of a loss as a result of the insurer's participatory activity.

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SVO Notching Guidelines

57. Deferral of dividends in a security denominated preferred stock is presumed to be subject to notching for credit risk subject to an SVO determination that the denomination is not truly reflective of the terms of the agreement in which case it may be more appropriately notched for other than credit risk.
58. In a given capital structure, the priority of payment due to an investor may be so subordinated as to require treatment under these guidelines for other non-payment risk. This is especially true where deep subordination is combined with a right to defer interest.



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

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

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

RE: Proposed Amendment to Define and Add Guidance for Structured Equity and Funds to the P&P Manual

DATE: November 28, 2022

Summary – The SVO has processed several private letter rating (PLR) filings for investments in notes issued by, and of equity or limited partnership interests in, a special purpose vehicle, trust, limited liability company, limited partnership or other legal entity that operates as a feeder fund which itself invests, directly or indirectly, in one or more funds or other equity investments. The SVO is concerned about this general structure for the following reasons:

- 1) Circumvent Regulatory Guidance - With the introduction of an intervening entity as debt issuer, if the investment is in substance an equity investment, the format of the investment circumvents regulatory guidance established by this Task Force, the Statutory Accounting Principles (E) Working Group and the Capital Adequacy (E) Task Force for the reporting of equity investments unless, in the case of funds, the SVO determines that the fund produces fixed-income like cash flows and is therefore eligible for specific classification, and that equity and fund investments are ineligible to use credit rating provider (CRP) ratings in the assignment of an NAIC Designation.

All non-SEC registered funds are required to be reported on Schedule BA. Life insurance entities are permitted to file investments in private equity funds, partnerships, limited liability companies and joint ventures to the SVO for specific classification on Schedule BA.;

- 2) Reliance on Ratings - These investments are being reported as bonds and receiving a bond risk-based capital (RBC) factor based upon the mechanical assignment of NAIC Designations that rely upon Credit Rating Provider (CRP) ratings through the filing exempt process. The use of CRP ratings would not be permitted for the fund or equity investments which underly these notes if the equity or fund investment were held directly;
- 3) RBC / Investment Limit Arbitrage - The structure may permit in-substance equity and fund investments to obtain improved RBC treatment than what would be received if the investment had been directly reported. In addition to improved RBC treatment, the structures could permit entities to hold more underlying equity / fund investments than what would be permitted under state investment law; and

- 4) **Transparency** - The structures typically use two or more interconnected non-public private entities through which the non-public and privately rated “bond” securities are issued that are backed by investments in non-public assets. The many non-public private layers deny regulators, and possibly insurer investors, transparency into the true underlying risks, credit exposure and nature of the investment. The notes issued are described generically as a “senior note” or “term loan” further obscuring their actual structure and complexity. These structures can invest in any asset including affiliate investments, non-fixed income investments, derivatives, borrowings for the purpose of leverage and non-admitted assets.

It is possible that many of the transactions the SVO has processed would not qualify as bonds eligible for Schedule D-1 reporting according to the principles-based bond definition currently being drafted by the Statutory Accounting Principles (E) Working Group, while others likely will qualify. The bond definition requires a review of the substance of the investment to determine whether it has the substance of a bond; most significantly, that the ultimate underlying collateral has fixed income cash flows. In either case however, the use of a fund intermediary has the potential to be abused and requires significant judgment to understand the substance and nature of the ultimate underlying risk. This has already been recognized by the establishment of processes for the SVO to provide NAIC Designations for fixed-income-like funds. It would then follow that debt instruments backed by the types of funds that would ordinarily be required to be filed with the SVO, should follow the same process.

Regulatory Guidance - As noted in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual), Part One, Policies of the NAIC Valuation of Securities (E) Task Force, paragraph 112:

The “fixed-income-like” regulatory treatment accorded under this Section only applies to funds that the SVO has verified meet eligibility criteria established by the VOS/TF and been assigned NAIC Designations or reviewed under the verification procedures and added to an NAIC List or other NAIC compilation process as hereafter discussed in this section. The use of NAIC CRP credit ratings under the filing exempt process discussed in Part Three of this Manual shall not be an acceptable basis to apply for and receive the regulatory treatment specified in this section.

Equity and fund investments that are structured through another legal entity have been able to qualify as ‘bonds’ under the current definition due to their legal form (instead of substance as with the proposed bond definition) and bypass reporting requirements for equity and fund investments. These structures have sometimes been referred to generically as “Rated Notes”, but they may be called other names. The name may change but the general framework is the same: an equity or fund investment is transformed into what the insurer reports as a bond through the insertion of an intervening entity, which issues a note that, due to a CRP rating, receives the statutory treatment of a bond for accounting, reporting, RBC and NAIC Designation purposes. This process exploits the inherent weakness within the Filing Exempt process where anything with a CRP rating is assumed to be a “bond” and automatically treated as such despite its underlying assets, structure, or risk. These transactions can also permit the deferral of interest and/or principal payments, sometimes without capitalization and without being an event of default, introducing additional other non-payment risks not reflected in the CRP ratings used in the FE process.

Example Structures and RBC Impact – The typical structure for these investments starts with a source entity, the Main Fund in *Figure 1*, that holds the underlying assets, which may be fixed income investments, but there can be many variations in the type and nature of the underlying asset. If the Main Fund, managed by General Partners (GP), were to sell Limited Partnership Interests (LP Interest) directly to an insurer, as investor, the LP Interest would typically fall under SSAP No. 48 – Joint Ventures, Partnerships and Limited Liability Companies and be reported on Schedule BA. The investment would then receive an equity RBC charge unless filed with the SVO for a NAIC Designation. However, in a structured equity and funds transaction, an investor in the Main Fund is able to circumvent regulatory guidance when the LP Interest is routed through an intermediate private entity, the Debt Feeder Fund in *Figure 1*, which issues one or more tranches of notes and possibly a small equity or limited partnership interest in itself.

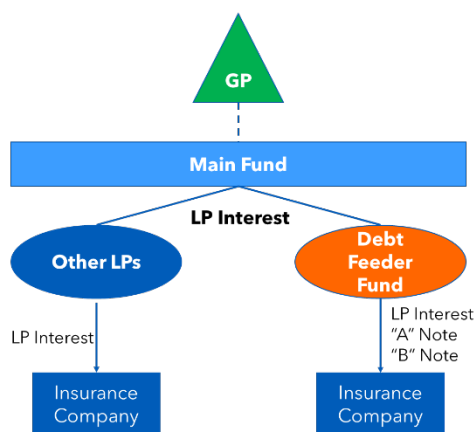


Figure 1

In the PLR filing that alerted the SVO to this type of investment, the assets underlying the structure were purported to be “B” quality fixed income investments. Specific details about the underlying investments were not provided and there was no transparency as to whether they were bonds, mortgage loans, real estate, affiliate notes or some other type of asset. The transaction was described as a Debt Feeder Fund issuing “investment units” comprised of 90% Senior Notes and 10% limited partnership interest, implying that the investor must participate in both, though this joining of the note to equity may not always be required in other structures. The weighted average life of the assets was identified as four-years but the Senior Notes had a remaining term of 12 years and paid interest of 8.00%, which could be deferred without capitalization. The Senior Notes were rated BBB+ by a CRP.

The issuing Debt Feeder Fund sells the “investment units” (a note and LP Interest) to insurers who report the note as a “bond” under SSAP No. 26R – Bonds and the small portion of equity as a joint venture or LP Interest under SSAP No. 48 – Joint Ventures, Partnerships and Limited Liability Companies. There is no transparency that the notes issued by the Debt Feeder Fund are backed only by a separate LP Interest in the Main Fund. Either directly or indirectly, an investment in a limited partnership interest or equity investment is transformed into a “bond” because of its legal structure, without any review of its substance as a fixed-income instrument, which would be required under the proposed bond definition and is required today in the P&P Manual in order to assign an NAIC Designation to non-registered private funds with underlying assets having characteristics of bonds or preferred stock.

Continuing this example in *Figure 2*, the Debt Feeder Fund, as issuer, issues \$90 million in notes and \$10 million in LP interests that are purchased by insurers. The \$100 million in total proceeds are used by the Debt Feeder Fund to acquire an LP Interest in the Main Fund. The Main Fund uses proceeds from Debt Feeder Fund's LP Interest investment to invest in what are reported to be "B" rated fixed income securities

By investing in the investment units issued by the Debt Feeder Fund, an insurer is able circumvent regulatory guidance by transforming the Main Fund's investments in "B" rated loans into a much higher rated note due to the intervening legal entity. An insurer investing in the investment unit (note and equity) would be able to dramatically reduce its risk-based capital versus reporting an LP Interest investment in the main fund holding "B" rated loans but be exposed to identical economic risk. Using the information provided in the

Rating / NAIC Designation	RBC Factor	Own Directly	Own through Issuing Entity
BBB+ / NAIC 2.A	1.261%		\$ 90
...			
B / NAIC 4.B	9.535%	\$ 100	
...			
Equity / NAIC 6	30.000%		\$ 10
Total Investment		\$ 100	\$ 100

Resulting RBC	9.535%	4.135%
RBC Arbitrage Opportunity	-5.400%	
% reduction	-56.635%	

Figure 2

PLR implies, as noted in *Figure 2*, the insurer making this investment could reduce its risk-based capital by 56.6%, an RBC factor reduction of 5.40%, if it invested in the investment unit (note and equity) with the note rated by a CRP instead of investing in the underlying assets directly while maintaining the exact same economic exposure. If a Health or Property Casualty insurer invested in this structure the risk-based capital arbitrage advantage could be significantly higher because those insurers cannot take advantage of an SVO assigned NAIC Designation for a Schedule BA Non-Registered Private Fund with Underlying Assets Having the Characteristics of Bonds or Preferred Stock in their RBC reporting schedules. If the note's NAIC Designation was not derived from this CRP PLR rating, the risk-based capital arbitrage neutral NAIC Designation Category for the notes would be an NAIC 4.A and the LP Interest would receive an NAIC 6 equivalent treatment. It is worth noting that the difference in this example is similar in concept to the RBC reduction that occurs through a CLO from owning the underlying loans directly.

Another example transaction that the SVO received as a PLR filing in which a private equity interest is converted into a “bond” involves a limited liability corporation (LLC) whose sole asset is an equity interest in a commercial real estate investment brokers partnership. The LLC issues two term loans, Term Loan A for \$55 million with a CRP rating of BBB- and Term Loan B for \$55 million with a CRP rating of BB. The LLC’s only source of revenue to make scheduled payments is from distributions on the partnership equity investment but this is not transparent because the investments are reported as bonds. Interest and principal payments on the Term Loans are both permitted to accrue and non-payment does not constitute an event of default. The Term Loans are subordinate to other payment obligations of the LLC including administrative fees. The PLR mentioned that a prior issuance prioritized the payment of the LLC’s management fees above payments to investors, which implies it possessed additional risk.

Rating / NAIC Designation	RBC Factor	Own Directly	Own through Issuing Entity
BBB- / NAIC 2.C	2.168%		\$ 55
...			
BB / NAIC 3.B	4.537%		\$ 55
...			
Equity / NAIC 6	30.000%	\$ 110	
Total Investment		\$ 110	\$ 110

Resulting RBC	30.000%	3.353%
RBC Arbitrage Opportunity	-26.648%	
% reduction	-88.825%	

Figure 3

From this information the SVO estimated in *Figure 3* that an insurer could reduce its risk-based capital by 88.8%, an RBC factor reduction of 26.65%, if they purchased the two Term Loans instead of reporting the equity investment in the partnership. If the notes did not rely upon a CRP rating for assignment of an NAIC Designation, the risk-based capital arbitrage neutral NAIC Designation Category for them would be an NAIC 6 as the underlying investment is equity.

Recommendation – Given the magnitude of these RBC arbitrage opportunities, the judgment involved in assessing the nature of the ultimate risk, the lack of transparency, circumvention of regulatory guidance and the reliance on CRP ratings to accomplish these ends, the SVO proposes amending the P&P Manual to include a definition for Structured Equity and Fund and to exclude such investments from Filing Exemption eligibility. The proposed amendment would not change how the investment is classified for reporting by the insurer but it would ensure that the NAIC Designation and Category assigned are appropriate for the risk and eliminate this version of RBC arbitrage.

Proposed Amendment - The proposed text changes to the P&P Manual are shown below with additions in red underline and deletions in ~~red-strikethrough~~, as it would appear in the 2022 P&P Manual format.

PART ONE
POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE



POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

...

STRUCTURED EQUITY AND FUNDS

Intent

118. Transactions meeting the criteria of Structured Equity and Funds as defined in Part Three of this Manual must be submitted to the SVO for review.

NOTE: See “Structured Equity and Funds” in Part Three for filing instructions, documentation requirements and methodology applicable to Structured Equity and Funds investments.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

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

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Specific Populations of Securities Not Eligible for Filing Exemption

1. The filing exemption procedure does not apply to:

...

- Structured Equity and Funds - Transactions meeting the criteria of Structured Equity and Funds as specified in this Manual are not eligible for filing exemption and are subject to assessment by SVO.

STRUCTURED EQUITY AND FUND

Definition

320. A Structured Equity and Fund investment is a note issued by, or equity or limited partnership interest in, a special purpose vehicle, trust, limited liability company, limited partnership, or other legal entity type, as issuer, the contractually promised payments of which are wholly dependent, directly or indirectly, upon payments or distributions from one or more underlying equity or fund investments. The inclusion of an intervening legal entity or entities between the Structured Equity and Fund investment issuer and the underlying equity or fund(s), does not change the risk that the insurer investment is ultimately dependent, in whole or in part, upon an investment in equity or one or more funds and its underlying investments. Any design that circumvents this definition, and related examples, through technical means but which in substance achieves the same ends or poses the same risk, shall be deemed a Structured Equity and Fund.

Example Transactions

321. Example 1 - The Structured Equity and Fund issuing entity issues a note and a small equity or limited partnership interests in itself. The Structured Equity and Fund investment issuer invests the issuance proceeds directly or indirectly in other underlying investments that may or may not be admitted assets or fixed income like. The insurer may invest in the notes or equity, and may be required to invest in both as part of an investment unit. The Structured Equity and Fund issuer in this example is a feeder fund that issues \$90 million in notes and \$10 million in limited partnership interests and uses the \$100 million in total proceeds to invest, either directly or indirectly through a main fund, in "B" rated securities. Insurers purchase investment units comprised of 90% Senior Notes and 10% limited partnership interest. The bonds are described as Senior Notes with an interest of 8.00% but interest payments can be deferred without capitalization. The Senior Notes were rated BBB+ by the CRP.

322. Example 2 - The Structured Equity and Fund issuing entity is a limited liability corporation (LLC) whose sole asset is an equity interest in a commercial real estate investment brokers partnership. The private equity interest is converted into a bond through an intervening LLC entity that issues two Term Loans, both of which received a NAIC CRP rating. The LLC issues two term loans, Term Loan A for \$55 million with a NAIC CRP rating of BBB- and Term Loan B for \$55 million with a NAIC CRP rating of BB. The LLC's only source of revenue to make scheduled payments on the Term Loans is from distributions from its equity investment in the partnership. Interest and principal payments on the Term Loans are both permitted to accrue and non-payment does not constitute an event of default. The Term Loans are subordinate to other payment obligations of the LLC including administrative fees and management fees.

REQUIRED DOCUMENTATION AND ANALYTICAL PROCEDURES

Documentation

323. An insurance company investing in a Structured Equity and Fund issuance shall provide information sufficient for the SVO to conduct a look through assessment and credit risk assessment, as described below in this section. The entity issuing the Structured Equity and Fund may also provide this information through a completed RTAS Application sponsored by the insurer (Information about the RTAS process is contained here: www.naic.org/documents/svo_rtas_app.pdf). The following additional information is required for a Structured Equity and Fund:

- Disclosure of any Subsidiary, Controlled or Affiliated relationship, as described in this manual and the *Accounting Practices & Procedures Manual*, between the issuer, any intermediate entity, any of the underlying investments, including the parties from which they were acquired, and the insurer.
- Prior four quarterly financial statements, if produced, and trustee or collateral agent reports from the Structured Equity and Fund issuer sufficient to identify: security specific details of each underlying investment (security identifier, descriptive information, all Eligible NAIC CRP Credit Ratings (if any), par value, market value, and explanation as to how the market value was determined).
- The legal agreement(s) governing the Structured Equity and Fund structure, the securities it issues, investments it has made and any other agreement potentially impacting payments to investors; including, but not limited to, Prospectus and Statement of Additional Information (SAI), the Private Placement Memorandum, Limited Partnership Agreement or Limited Liability Company Agreement, the Subscription Agreement, the Form D, if one has been filed, and any sale or transfer agreements.
- Schedules of the fund's portfolio securities and assets with a description of the security, the CUSIP or other security identifier and NRSRO credit ratings for the last four quarters of the fund's existence. For funds which use derivative transactions or other derivative instruments, the schedule shall include information for each derivative.

Analytical Procedures

324. Credit Risk Assessment – The SVO may, in accordance with authority granted to it Part One, apply any methodology it deems appropriate to assess the credit risk of a Structured Equity and Fund issuance and its ultimate underlying assets identified pursuant a look-through assessment. Such methodologies include, but are not limited to, a weighted average rating factor (WARE) methodology or a CRP’s rating rationale analysis of the issuance, notched as the SVO deems appropriate to eliminate any risk-based capital arbitrage that may exist through this structure.

The NAIC Designation and Category assigned to each security issued by the Structured Equity and Fund issuer may also be adjusted to reflect any credit support within the structure including, but not limited to, subordination, guarantees, insurance, or equity. The objective of the SVO’s analysis is to ensure that the overall risk assessment will be risk-based capital neutral when comparing the ultimate underlying assets to the securities issued by the Structured Equity and Fund.

325. Look-through Assessment – A qualitative and quantitative evaluation of all securities and assets underlying a Structured Equity and Fund investment, encompassing the following criteria:

- Verify the type of assets and assess their credit risk, including performing an independent assessment of credit risk, as necessary.
- Assess which assets are consistent with a fixed income like investment and which assets are equity in nature.
- Review each underlying fund for consistency with the NAIC Funds List guidelines provided in this manual. Those which do not meet the guidelines for inclusion on a NAIC Funds List shall be deemed to have a NAIC 6 Designation for purposes of the credit risk assessment.
- Evaluate the extent to which the composition of a Structured Equity and Fund’s underlying investment(s) in a fund(s) can vary under normal market conditions given the underlying fund’s policies and investment strategies and the extent to which the composition of the underlying fund’s portfolio may vary under abnormal market conditions and the extent to which changes in composition of the underlying fund’s portfolio in abnormal market conditions may persist given the underlying fund’s leverage profile or other relevant factors.

Methodology

326. The SVO shall:

- Conduct a look-through assessment (as explained above in this section).

- Conduct a credit-risk assessment (as explained above in this section) to determine the credit risk of the Structured Equity and Fund's underlying assets and cash flows sufficient to make cash payments to the investors in the securities issued.

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/00 Work in Progress/Structured Equity and Funds/2022-xxx.xx Task Force 2022 Amend PP Structured Equity and FundsV10.docx>



MEMORANDUM

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

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

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

RE: Non-substantive technical amendment to the Purposes and Procedures Manual clarifying the corresponding NAIC Designation Category for NAIC 5GI

DATE: November 15, 2022

Summary – At the 2021 Fall National Meeting the Task Force adopted a non-substantive technical amendment to the PL Securities section in Part Three of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office (Purposes and Procedures Manual)* which clarified that an NAIC 5GI Designation is the equivalent of an NAIC 5.B Designation Category. The SVO has identified other places in the *Purposes and Procedures Manual* where the 5GI.B Designation Category is not currently specified and proposes a non-substantive technical amendment to make the changes shown below in red (additions underlined and deletions with ~~striketrough~~).

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS
APPLICABLE TO THE SVO

COMPILATION AND PUBLICATION OF THE SVO LIST OF INVESTMENT SECURITIES

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RMBS/CMBS Modeled Securities Process

7. RMBS and CMBS that are deemed to be subject to financial modeling are retained in the RMBS/CMBS Modeled Process. RMBS and CMBS that are deemed ineligible for financial modeling but that have been assigned credit ratings by NAIC CRPs migrate to the Filing Exempt Securities Process. RMBS and CMBS that are deemed ineligible for financial modeling and that have also not been assigned credit ratings by NAIC CRPs may be reported by the insurer in the **5GI NAIC General Interrogatory** with an NAIC 5GI and an NAIC Designation Category of 5.B GI.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

PRODUCTION OF NAIC DESIGNATIONS

...

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION

27. An insurance company that self-assigns a 5.B GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.
28. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5.B GI are not met.
29. Securities with NAIC 5.B GI Designations Categories are deemed to possess the credit characteristics of securities assigned an NAIC 5.B Designation Category. A security assigned an NAIC 5.B GI Designation Category incurs the regulatory treatment associated with an NAIC 5.B Designation Category.
30. Securities an insurance company previously assigned as NAIC 5.B GI are permitted to subsequently receive this NAIC 6* Designation Category if the requirements for an NAIC 5.B GI Designation Category continue to be met.
31. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.
32. Securities that are residual tranches or interests, as defined in *SSAP 43R – Loan Backed and Structured Securities*, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5.B GI Designation Category or NAIC 6* Designation.

NOTE REGARDING RESIDUAL TRANCHES OR INTERESTS: For 2021 year-end reporting only, residual tranches or interests previously reported on Schedule D-1: Long-Term Bonds shall be permitted to be reported on Schedule D-1 with an NAIC 6* Designation, however an NAIC 5GI is not permitted.

NOTE: The GI after the quality indicator 5.B refers to General Interrogatory and distinguishes NAIC 5.B GI from an NAIC 5.B Designation Category. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.

REGULATORY TRANSACTIONS

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Status of Regulatory Transactions

290. A Regulatory Transaction is not eligible for:
- Assignment of an NAIC Designation by the SVO;
 - The filing exemption process for publicly rated securities;
 - The private letter rating component of the filing exemption or for use of the PLGI designation symbol;
 - Self-assignment by an insurer of the administrative symbol Z under the 120-rule;
 - Self-reporting by an insurer on the general interrogatory for securities eligible for filing exemption but for which no NAIC CRP credit rating is available (i.e., 5.B GI) and
 - Inclusion in the SVO List of Investment Securities or any other NAIC electronic system or processes maintained for operations for the VOS/TF



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

FROM: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau
Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)

RE: Proposed Methodology for Modelling CLOs

DATE: December 12, 2022

Summary – A collateralized loan obligation (CLO) is type of structured security backed by a pool of debt, typically corporate loans with low credit ratings. During the Summer National Meeting the Valuation of Securities (E) Task Force (VOS) exposed a proposal to have SSG model CLOs.

Methodology Recommendation – Pending the decision of VOS regarding the financial modeling of CLOs as well as the Risk-Based Capital Investment Risk and Evaluation (E) Working Group (RBCIREWG) decision with respect to the addition of higher capital charges, SSG has been asked to expose the methodology which would be used to model CLOs.

The methodology presented in Annex A hereto, is based on SSG's annual CLO stress tests. Critically, it excludes the Scenarios to be used in the process. SSG believes that the discussion of the Scenarios is expected to be more in depth and require more time once the methodology is agreed upon.

The assumptions presented here cover the mechanics of the modeling process and cash flow. A consensus on these assumptions will allow a more cogent discussion of the Scenarios and their impact.

Questions Posed to Interested Parties:

1. Are there any other Assumptions (other than Default / Recovery Rate) that will allow market participants to completely replicate the work of NAIC for broadly syndicated loan CLOs?
2. Are these Assumptions reasonable? Please consider that the Default and Recovery Rate Assumptions will come later and that there will be ample opportunity to comment on how these perform on actual CLOs replicated by market participants.
3. Any other issues that you wish to bring to our attention.

For any alternative assumptions or assumptions deemed unreasonable, please provide the following:

- a) An actionable alternative which can be replicated by the NAIC and market participants.
- b) A quantitative justification for such an alternative based on all available historical date (not just the 2011-2019 economic expansion, for example).



- c) References to whether such alternative is used by rating agencies in their public published methodologies and whether it contemplates a trade-off (for example between the timing of recovery and the amount recovered). Specific citations to publications will be greatly appreciated.



ANNEX A

NAIC Collateralized Loan Obligation (CLO) Stress Tests Methodology

Scope

- We will model all tranches of broadly syndicated loan CLOs held by U.S. insurance companies.
- At this stage we will exclude:
 - Commercial real estate (CRE) CLOs – The risk is commercial real estate, and different assumptions are required.
 - Re-securitizations, asset-backed securities (ABS), collateralized debt obligations (CDOs) and trust preferred securities (TruPS) CDOs – They are out of scope.
 - Middle market CLOs – They are temporarily excluded, as the asset class requires specialized assumptions. We hope to return to these assets shortly.
- Another limitation is the availability of the specific CLO via our third-party software vendor.

Givens

- These will be determined via the “Scenario” portion of the process following the setting of the methodology.
- Assume that the inputs are periodic “partial” default rates for each loan based on the current rating.
- In addition, assume each loan has a recovery rate, based on its seniority, for that period.

Assigning Ratings to Underlying Assets

- Historical default rates are reported at the **issuer** level, while the debt instrument typically has an **issue** rating, which may be different. The issuer rating is used to calibrate the default rate, while the issue rating influences the recovery rate.
- We propose the following logic:
 - If an asset has an **Issuer** rating available within our third party software (generally those reported by Moody, Standard & Poor’s (S&P) or Fitch), that rating will be used to set the applicable default rating.
 - Otherwise, if an asset has an **Issue** rating available within our third party software (generally those reported by Moody, S&P or Fitch) that rating will be adjusted to set the applicable default rating as follows:
 - Asset is reported as Senior Secured Loan or Senior Unsecured Bond: default rating = **Issue** rating + 1 notch (i.e. higher default probability)
 - Otherwise: default rating = **Issue** rating
 - This is different from our stress tests
 - If the Securities Valuation Office has assigned an NAIC Designation Category to the Issue, that NAIC Designation Category will be used, unadjusted.



- Once a default rating has been established, the loan will be assumed to “partially default” until its maturity.

Recovery Rate

- Principal is recovered 6 months (2 periods) after default

Cash Flow Assumptions

- **Interest Rates / Proceeds**
 - Forward Secured Overnight Financing Rate (SOFR) curve as of evaluation date
 - Interest Proceeds for each period are based on the weighted average current portfolio spread plus the applicable base rate times the non-defaulting principal.
- **Maturities and prepayments**
 - Non-defaulting portions of each loan mature based on the legal maturity
 - No prepayments assumed
- **Reinvestment**
 - No post-reinvestment period reinvestment
 - Reinvestment collateral is purchased at par
 - Reinvestment occurs before payment date – i.e., there are no principal proceeds in the waterfall that can be used to pay interest or satisfy overcollateralization (O/C) tests
 - Reinvestment is assumed to have a rating equal to the transaction’s weighted average rating factor (WARF). If the WARF is not reported, then it is assumed to be 4.C (B3) and is defaulted as stated above.
 - Reinvested collateral is tracked per reinvestment bucket (e.g., all reinvested collateral in one time period is tracked separately from collateral reinvested in another time period).
- **Event timing**
 - Periodic payment on identified collateral – as per loan terms
 - Periodic payment on reinvested collateral – quarterly
 - Collateral defaults on its interest payment date (prior to paying interest or principal)