NAIC NATIONAL MEETING SUMMER 2022

Date: 7/28/22

2022 Summer National Meeting
Portland, Oregon

VALUATION OF SECURITIES (E) TASK FORCE
Thursday, August 11, 2022
2:00 – 3:00 p.m.
Oregon Convention Center—Portland Ballroom 252–253—Level 2 -

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		Arizona
Ricardo Lara	Laura Clements	California
Andrew N. Mais	Kenneth Cotrone	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
Chlora Lindley-Myers	Debbie Doggett	Missouri
Eric Dunning	Lindsay Crawford	Nebraska
Marlene Caride	Nakia Reid	New Jersey
Adrienne A. Harris	Jim Everett	New York
Cassie Brown	Amy Garcia	Texas
Jon Pike	Jake Garn	Utah
Mike Kreidler	Tim Hays	Washington

NAIC Support Staff: Charles A. Therriault/Marc Perlman

AGENDA

Consider for Adoption:

1. Consider Adoption of its June 9 and Spring National Meeting Minutes — Attachment One, Attachment Two
   (Doc. ID: 2022.006.01 & 2022.007.01)—Carrie Mears (IA), Charles

A. Therriault (NAIC), and Marc Perlman (NAIC)

Discuss Comments and Consider for Adoption:

2. Discuss Comments Received 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 *(Doc. ID: 2022-002-01, 2022-002.02, and 2022-002-03)*
   —Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)

   Attachment Three
   Attachment Three-A
   Attachment Three-B

3. Discuss Comments Received and Consider Adoption of a Proposed Amendment to the P&P Manual to Update Part Four for NAIC Designation Category and Additional Price Points *(Doc. ID: 2022-003.01 and 2022-003.02)*
   —Carrie Mears (IA), Eric Kolchinsky (NAIC), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)

   Attachment Four
   Attachment Four-A

4. Discuss Comments Received and Consider Adoption of a Proposed Amendment to the P&P Manual to Update the Definition of Principal Protected Securities (PPS) *(Doc. ID: 2021-048.03, 2021-048.01, and 2021-048.02, 2021-048.04)*
   —Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)

   Attachment Five
   Attachment Five-A
   Attachment Five-B
   Attachment Five - C

Receive and Discuss Referral:

5. Receive and Discuss a Referral from the Statutory Accounting Principles (E) Working Group of the Related Party Reporting Agenda Item
   (Doc. ID: 2022.008-01, 2022.008-02, and 2022.008-03)
   —Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)

   Attachment Six
   Attachment Six-A
   Attachment Six-B

6. Receive and Discuss a Referral from the Macroprudential (E) Working Group on its Plan for the List of MWG Considerations *(Doc. ID: 2022.011-01, and 2022.011-02)*
   —Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)

   Attachment Twelve
   Attachment Twelve-A

Discuss, Receive Comments and Consider for Exposure or Referral:

7. Discuss and Consider Exposure of the Task Force's 2023 Proposed Charges
(Doc. ID: 2022.009-01)—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)

Attachment Seven

8. Discuss and Consider Exposure of a Staff Memorandum on Alternatives to Add Fixed Income Analytical Risk Measures to Investments Reported on Schedule D, Part One
(Doc. ID: 2021-053.01, 2021-053.02, 2021-053.03, 2021-053.04, and 2022-053.05)—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)

Attachment Eight
Attachment Eight-A
Attachment Eight-B
Attachment Eight-C
Attachment Eight-D

9. Discuss and Consider Exposure of a Revised Proposed Amendment to the P&P Manual to Update the Definition of Other Non-Payment Risk Assigned a Subscript "S"
(Doc. ID: 2021-047.01, 2021-047.02, and 2022-047.03)—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)

Attachment Nine
Attachment Nine-A
Attachment Nine-B

10. Receive Comments on IAO Issue Paper on the Risk Assessment of Structured Securities – CLOs *(Doc. ID: 2022-004.01, 2022-004.02, 2022-004.03, 2022-004.04, 2022-004.05, 2022-004.06, 2022-004.07, 2022-004.08, 2022-004.09, 2022-004.10)—Carrie Mears (IA), Eric Kolchinsky (NAIC), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)*

Attachment Ten
Attachment Ten–A-I

Hear or Receive Staff Reports:

11. Receive a Report on the Projects of the Statutory Accounting Principles (E) Working Group
—Carrie Mears (IA) and Julie Gann (NAIC)

12. Receive an Update on the Ad Hoc Credit Rating Provider (CRP) Study Group—*Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)*

13. Receive an Update from the Structured Securities Group (SSG) on Modeling and Scenarios *(Doc. ID 2022-010.01)—Carrie Mears (IA) and Eric Kolchinsky (NAIC)*

Attachment Eleven

14. Discuss Any Other Matters Brought Before the Task Force

15. Adjournment

Draft Pending Adoption

Draft: 4/21/2022

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

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

1. Adopted its 2021 Fall National Meeting Minutes

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

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

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

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

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

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

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

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

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

Charles Therriault (NAIC) said this agenda item is closely related to the last one in that PPS are a type of subscript "S" security. Securities that possess "Other Non-Payment Risks" are intended to be reviewed by the SVO, but these investments have not been explicitly included on the list of Specific Populations of Securities Not Eligible For Filing Exemption in Part Three of the P&P Manual. Securities with other non-payment risks are identified through assignment of the Administrative Symbol "S" as a subscript to the NAIC designation. This amendment would add "Securities with Other Non-Payment Risks" to the list of securities that are ineligible for filing exemption.

As noted in Part One, paragraph 90, of the P&P Manual, "An objective of the VOS/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is required to identify securities that contain such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer, so this can be reflected in the NAIC Designation assigned to the security through the application of the notching process."

The proposed amendment clarified through additional illustrations securities that would also be considered as having "Other Non-Payment Risks." Based on comments received, The SVO requests the Task Force's approval to work with industry on modifying the language and fine-tuning the amendment to avoid any unintended consequences.

Draft Pending Adoption

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

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

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

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

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

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

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

Draft Pending Adoption

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

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

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

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

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

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

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

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

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

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

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

Draft Pending Adoption

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

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

Mr. Perlman said the SVO recommends updating the instructions in Part Three of the P&P Manual to include guidance related to the assignment of NAIC designations to Schedule BA assets with underlying characteristics of bonds or fixed income instruments. Part One of the P&P Manual currently permits the SVO to assign NAIC designations to Schedule BA assets with underlying characteristics of bonds or fixed income instruments, but there is currently no specific guidance for the SVO in Part Three of the P&P Manual. Including the proposed provisions would enable the SVO to assign NAIC designations to Schedule BA assets that are not expressly covered by other sections of the P&P Manual (such as Schedule BA Funds). Schedule BA assets for life and fraternal insurers would benefit from NAIC designations because they would be eligible for more favorable RBC treatment. The SVO's authority to assign NAIC designations to certain Schedule BA assets already exists. Part One of P&P Manual states: "The SVO is assigned to assess investment securities reported to state regulators on Schedule D and Schedule BA." Additionally, the P&P Manual also explains in Part One that to be eligible for the assignment of an NAIC designation, a Schedule BA asset must have underlying characteristics of a bond or fixed income instrument.

This proposed amendment would potentially make various types of assets eligible for an NAIC designation that currently are not. Each asset would need to be individually assessed by the SVO for bond or fixed income characteristics. At this time, the SVO recommends that SVO staff continue working with industry on this topic.

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

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

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

Ms. Mears said the Task Force has gone through several iterations of this amendment over the past year. With the current version, exposed at the 2021 Fall National Meeting, the SVO reintroduced a proposal under which the Task Force would give the SVO discretion to notch down from the parent's rating in certain circumstances. It adheres very closely to an earlier version of the proposal.

Mr. Perlman said as the Task Force is probably aware of by now, the SVO received comments from certain insurers and other interested parties that it should assign NAIC designations to working capital finance investments (WCFI) with unguaranteed and unrated obligors, based on the implied support from an obligor's NAIC CRP-rated parent even though the SVO found no generally accepted analytical technique or methodology to support the assumption that a parent entity will necessarily support its subsidiary in times of financial distress.

Draft Pending Adoption

The current draft of the amendment, exposed at the 2021 Fall Nation Meeting, is substantially like the original amendment and reflects the comments from some Task Force and Statutory Accounting Principles (E) Working Group members that they would like the SVO to retain discretion to notch down, as it deems appropriate. Like the November 2020 amendment, the Task Force would direct the SVO to imply the parent's support of its subsidiary and would give the SVO discretion to assign an NAIC designation to the subsidiary that is lower than that of the parent based on its assessment of the parent/subsidiary relationship. However, this current proposal clarifies that if the SVO notches the NAIC designation of a subsidiary obligor down from that of its parent, resulting in a credit assessment below an NAIC 2, the WCFI program would not be eligible for an NAIC designation because it would no longer meet the definition of an eligible "obligor" in *SSAP No. 105R—Working Capital Finance Investments*.

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

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

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

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

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

Mr. Therriault said the SVO was made aware of regulators or insurers in non-U.S. jurisdictions, such as the Bermuda Monetary Authority (BMA) and Japan's Financial Services Agency (FSA), either referencing NAIC designations in their regulatory processes or wanting to reference them. The P&P Manual is specific in that NAIC designations are only intended for NAIC members consisting of the chief insurance regulators of the 50 states, the District of Columbia, and five U.S. territories. For example, the P&P Manual says of the intended, proper, and authorized use of NAIC designations, the following:

1. An NAIC designation for quality (NAIC designation) of a security is produced solely for NAIC members who should interpret the designation for quality, in the context of the NAIC Financial Regulation Standards and

Accreditation Program, a member's state insurance laws and regulations, and the regulatory or financial solvency profile of a specific insurance company.

2. Because an NAIC designation is not produced to aid the investment decision-making process, NAIC designations are not deemed to be suitable for use by anyone but NAIC members.
3. NAIC designations are not intended to be and should not be used as if they were the functional equivalent of the credit ratings of NRSROs or other rating organizations whose ratings are intended to be used by investors as predictive opinions of default risk.
4. The use or adoption of NAIC designations by anyone other than NAIC members is improper and is not authorized by the NAIC.
5. NAIC designations and other analytical products of the SVO and Structured Securities Group (SSG) are produced solely for the benefit of NAIC members in their capacity as state insurance department officials for use in the NAIC Financial Regulation Standards and Accreditation Program.

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

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

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

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

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

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

8. Heard a Report from the SVO on Carryover Filings

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

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

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

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

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

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

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

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

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

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

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

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

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

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

11. Received an Update on the Ad Hoc Study Group

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

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

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

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

12. Discussed Other Matters

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

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

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

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Draft: 7/13/22

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

7. Discussed Other Matters

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

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

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

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

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

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: Update to the Purposes and Procedures Manual of the NAIC Investment Analysis Office clarifying the SVO's role regarding accounting and reporting

DATE: May 23, 2022

Summary - Historically, the SVO has worked with our statutory accounting colleagues to make accounting and reporting determinations which guided whether the SVO could analyze and designate an insurer's investment. The Purposes and Procedures Manual of the Investment Analysis Office (the "P&P Manual"), however, currently provides conflicting guidance on whether the SVO should have a role interpreting accounting and reporting guidance. While many sections of the P&P Manual state that the SVO may assign NAIC Designations to any investment filed with it for which it has a methodology, it also specifies in Part One, Paragraph 40 that the SVO is assigned to assess investments reported on Schedules D and BA and shall communicate to insurers if an investment is not eligible for those schedules and can therefore not be assigned an NAIC Designation.

Part One, Paragraph 32 of the P&P Manual explains that the assessment of an investment's credit risk is distinct from the determination of statutory accounting or reporting under the Accounting Practices & Procedures Manual ("AP&P):

> **NAIC Designations Do Not Communicate Statutory Accounting or Reporting -** The assessment of credit risk for an obligation or asset, as specified in the P&P Manual, is a separate and distinct process from the determination of statutory accounting or reporting under the AP&P Manual. The manner in which an NAIC Designation is used within statutory accounting guidance is limited to that, if any, specified in a Statement of Statutory Accounting Principles (SSAP) and cannot be derived or implied by language in the P&P Manual. Obtaining an NAIC Designation does not change an investment's applicable SSAP, annual or quarterly statement reporting schedule, or override other SSAP guidance required for the investment to be an admitted asset. There are limited instances in which a SSAP specifically identifies, within its scope, the inclusion of specific SVO-Identified investments. The SVO review required for an investment to be included on an SVO listing is a separate evaluation process that focuses on the structure of the investment. This process is distinct from the SVO's assessment of an investment's credit risk, which results in a NAIC Designation. As stated in the Statutory Hierarchy, Section V of the Preamble,

the AP&P Manual is the highest level of authoritative guidance.

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

> **Sources and Application of Statutory Accounting Guidance -** The authority to determine and interpret existing statutory accounting guidance in, or to develop new statutory accounting guidance for, the AP&P Manual, is a charge assigned by the Financial Condition (E) Committee through its Accounting Practices and Procedures (E) Task Force to the Statutory Accounting Principles (E) Working Group. The application of statutory accounting guidance to any specific obligation or asset to determine its status under the AP&P Manual is the obligation of the insurance company and its management. The state of domicile is the final authority with respect to statutory accounting and reporting guidance. Deviations from the authoritative guidance in the Statutory Accounting Hierarchy are reflected as a permitted or prescribed practice.

Part One, Paragraph 34 of the P&P Manual expressly states that the SVO can assess any investment filed with it, so long as it has the methodologies to do so:

> **Impact on SVO Operations -** Because SVO analytical determinations of credit quality do not convey opinions, conclusions or informational content relative to statutory accounting status, the SVO may assign an NAIC Designation to any obligation or asset that is filed by an insurer, provided that its credit quality can be assessed consistently with the polices and methodologies specified in the P&P Manual.

Part One, Paragraph 40 of the P&P Manual, however, states that the SVO is assigned to assess investments reported on Schedules D and BA and that it may need to communicate to insurers that the investment is not eligible for reporting on Schedules D or BA and, therefore, cannot be assigned an NAIC Designation:

> **Authority to Direct Insurers on Reporting -** The SVO is assigned to assess investment securities reported to state regulators on Schedule D and Schedule BA. To fulfill its function SVO must be able to communicate to an insurer that has filed a financial instrument or security that the financial instruments or security is not an investment security eligible for reporting on Schedule D and Schedule BA. SVO may be required to communicate to an insurer that it must refile a financial instrument or security to another schedule. SVO may also have to communicate to an insurer that an instrument the insurer has filed does not meet the definition of an Investment Security in this Manual and is therefore not eligible to be assessed or that the financial transaction or security is a Regulatory Transaction that can only be assessed by the SVO but only in accordance with the procedures discussed in this Manual if requested by a state insurance department. When situations occur that require the SVO to communicate reporting or related statutory guidance to an insurer, SVO consults with Financial Regulatory Services Division staff to ensure the communication to the insurer is accurate.

Recommendation – The SVO recommends the below changes to P&P Manual Part One, Paragraph 40 to provide for consistent instruction to the SVO regarding its authority regarding accounting and reporting

guidance. The proposal would clarify, in accordance with Part One, Paragraph 34, that the SVO can assign NAIC Designations to investments which it does not think are eligible for Schedule D or BA reporting so long as it has the methodology to do so. The SVO, however, would have the authority, at its discretion, to notify the appropriate regulators of any investments which, 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, it being understood that such opinions would not be authoritative and might not reflect the opinion of the relevant state regulator.

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 PERTAINING TO SVO AND SSG OPERATIONS

. . .

Authority ~~to Direct Insurers~~ on Reporting

40. The SVO is assigned to assess investment securities reported by insurers to state regulators on Schedule D and Schedule BA. For the avoidance of doubt, the SVO's opinion that an investment is ineligible for reporting on Schedule D or Schedule BA shall not prevent the SVO from assigning an NAIC Designation to that investment. The SVO may, but is not obligated to, notify appropriate state regulators of an insurer's investment which, in its opinion, would not or might not be eligible for reporting on Schedule D or Schedule BA, regardless of the investment's NAIC Designation status. The SVO shall give its statutory accounting and reporting opinion, if requested to do so, as part of its Regulatory Treatment Analysis Service, it being understood that such opinion is not authoritative and may not reflect the opinion of the relevant state regulator. ~~To fulfill its function SVO must be able to communicate to an insurer that has filed a financial instrument or security that the financial instruments or security is not an investment security eligible for reporting on Schedule D and Schedule BA. SVO may be required to communicate to an insurer that it must refile a financial instrument or security to another schedule. SVO may also have to communicate to an insurer that an instrument the insurer has filed does not meet the definition of an Investment Security in this Manual and is therefore not eligible to be assessed or that the financial transaction or security is a Regulatory Transaction that can only be assessed by the SVO but only in accordance with the procedures discussed in this Manual if requested by a state insurance department. When situations occur that require the SVO to communicate reporting or related statutory guidance to an insurer, SVO consults with Financial Regulatory Services Division staff to ensure the communication to the insurer is accurate.~~

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-06-09 - Interim Meeting/03 - SVO Role regarding accounting and reporting/2022-002.01 Task Force 2022 Amend SVO Accounting Reporting.docx

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July 8, 2022

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

Dear Ms. Mears,

Re: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update the Role of the SVO Regarding Interpreting Accounting and Reporting.

The undersigned (ACLI, PPIA, NASVA) support the proposal in the exposure as it is important to be provide clarity to the P&P Manual whenever possible. The undersigned propose one slight modification (below in underline). Intended to clarify that the SVO would simultaneously notify the company when sharing the SVO's opinion on any particular security. This would serve as a courtesy to help ensure the company and its regulator have the same information in the likely event they need to reach a conclusion on the security in question.

> 40. The SVO is assigned to assess investment securities reported by insurers to state regulators on Schedule D and Schedule BA. For the avoidance of doubt, the SVO's opinion that an investment is ineligible for reporting on Schedule D or Schedule BA shall not prevent the SVO from assigning an NAIC Designation to that investment. The SVO may, but is not obligated to, notify appropriate state regulators of an insurer's investment which, in its opinion, would not or might not be eligible for reporting on Schedule D or Schedule BA, regardless of the investment's NAIC Designation status. <u>If the SVO notifies a state regulator</u>

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.

acli.com

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.

of their opinion, they will also simultaneously notify the filing company and/or the company on which the SVO is providing its state regulator an opinion. The SVO shall give its statutory accounting and reporting opinion, if requested to do so, as part of its Regulatory Treatment Analysis Service, it being understood that such opinion is not authoritative and may not reflect the opinion of the relevant state regulator.

Thank you for considering the undersigned comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey

Tracey Lindsey NASVA

John Petchler

John Petchler
on behalf of PPiA Board of
Directors

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-08-11 - Summer National Meeting/02 - SVO Role regarding accounting and reporting/ACLI Comment.docx

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July 8, 2022

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

Re: Staff Proposal to Update to the Purposes and Procedures Manual of the NAIC Investment Analysis Office Clarifying the SVO's Role Regarding Accounting and Reporting

Dear Ms. Mears and Task Force Members,

As an independent consultant and long-time observer of the work of the Valuation of Securities Task Force I appreciate the opportunity to comment on the captioned proposal.

Adoption of this proposal would empower the Securities Valuation Office to assign NAIC Designations to assets that do not meet the NAIC's own standards to qualify for reporting on Schedules D and BA. At the very least this is perplexing and it appears to be contradictory.

I recommend that the VOSTF not adopt this proposal at this time. More discussion and coordination is needed among relevant NAIC groups[1] as well as the supporting staff (notably the SVO and Structured Securities Group) to understand the intended and unintended consequences to assessing insurers' solvency and whether this change is truly necessary. Furthermore, the practical aspects of broadening the authority of the SVO need additional coordination and consideration.

Responsibility for Establishing Capital Requirements

It is clear from the extensive and detailed official record of the development of Risk-Based Capital[2] that it is the responsibility of the Capital Adequacy Task Force to determine the RBC factors for <u>all</u> assets. For bonds and preferred stock the basis for assigning an asset to a particular Class to determine its RBC factor is an estimation of the likelihood of its default. Thus it is the responsibility of the SVO to categorize individual issues of bonds and preferred stock into their appropriate Classes based on their credit quality, *i.e.* likelihood of loss given default. So the CATF fulfills the executive function of setting the factors and the SVO performs the administrative function involved in actually assigning the factors to individual assets based on their credit quality.

[1] The Risk-Based Capital Investment Risk and Evaluation Working Group, the Capital Adequacy Task Force, the Statutory Accounting Principles Working Group and this Task Force

[2] Bernard L. Webb and Claude C. Lilly III for the National Association of Insurance Commissioners, *Raising the Safety Net -- Risk-Based Capital for Life Insurance Companies,* First Edition, Kansas City, MO: National Association of Insurance Commissioners Publications Department, 1994

VOSTF & SVO Roles in Monitoring Investment Risks

An important element of solvency assessments and RBC in particular is monitoring new investment risks that insurers may be adding to their balance sheets. Historically, the SVO has been charged with being the "eyes and ears" of the VOSTF, and more broadly the NAIC and even insurance regulators, concerning all manner of investment risks that may affect insurer solvency. It then refers its observations to the appropriate NAIC decision-making entity or regulator, possibly along with recommendations.

The NAIC's processes for assigning Designations to bonds provides insurers with uniform inputs for their RBC calculations as specified by the CATF. So while the principal function of the SVO is to determine some of these Designations it and the VOSTF can and should pursue more comprehensive examinations of insurer asset risks beyond the RBC context as they serve insurance regulators. While doing so it is imperative, however, that the SVO continue to determine Designations with at least the level of accuracy required to compute RBC with reasonable accuracy. It is beyond the authority of staff, however, to invent new or independent standards. That would be the responsibility of the CATF.

Practical Issues

There are some very practical problems with this proposal. Unlike the Nationally Recognized Statistical Rating Organizations the SVO tends to "borrow" from various NRSROs their detailed ratings methodologies. The Securities and Exchange Commission requires the publication of these methodologies by the rating organizations it regulates. NRSROs are all accountable to the SEC, their regulator, for basing their ratings strictly on their published methodologies. If a bond is of low quality its rating will reflect that. If the NRSRO cannot determine that there will be sufficient resources to meet obligations then it is not permitted to rate the asset and it becomes NR (Not Rated). The SEC publishes a detailed report of its examinations of NRSRO compliance annually.[3]

The SVO, in addition to lacking its own published methodologies, declines to even disclose which of the many methodologies it uses in determining individual Designations. This is problematic in itself for a number of reasons (*e.g.* lack of transparency). It also raises the serious question of how the SVO could use methodologies the NRSROs have developed to rate <u>bonds</u> and then apply them to assets that the NAIC has determined are <u>not</u> bonds when it does not even disclose its use of methodologies for the bonds it does Designate.

Paradox

Obviously it is not reasonable to take methodologies developed for bonds and then apply them to assets that are determined not to be bonds. One response to this would be to not grant the SVO the authority sought in this proposal.

Another possibility is to examine very carefully the standards being developed by the NAIC that, for insurance regulatory purposes, would disqualify from bond treatment certain assets that the NRSROs would rate as bonds based on their published methodologies. At the NAIC there has been much thought and discussion attempting to arrive at a definition of what is a bond. Things are simpler for the NRSROs. There is no need for an NRSRO to develop arbitrary one-size-fits all standards. They do not need to define "what is a bond" because they only assign bond ratings to

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[3] Securities and Exchange Commission, Office of Credit Ratings, *Staff Report on Nationally Recognized Rating Organizations,* January, 2022, https://www.sec.gov/files/2022-ocr-staff-report.pdf

actual bonds that meet their published standards. The objectives of the NRSRO are to predict, as accurately as possible and with all available information, the likelihood that a given bond will have sufficient resources to pay as promised. In effect they use their methodologies to determine what is a ratable bond and they do this in each and every instance, not relying on generalized rules. Poorly supported issues receive poor ratings and very poorly backed issues are not rated at all (NR) whether they are "bonds" or not. Essentially "NR" means the NRSRO does not have an opinion of the credit quality of an asset and the ability of the issuer of that debt instrument to fulfill its obligations.

Admittedly the NRSROs are in a different position than the SVO. NRSROs are under no obligation to undertake the difficult and time-consuming process of developing methodologies for every type of asset. (The SEC regulation does require, however, that adopted methodologies must be reasonable and that they be adhered to). For that, as well as other reasons, the NRSROs can be selective concerning which assets they will and will not rate. If they cannot or will not accept an application they simply decline it. The SEC reviews and examines the work of the NRSROs and this imposes discipline on this process.

When it comes to the SVO, insurers can submit any asset to the SVO for a Designation and this can have the same result as with an NRSRO: a poor rating or a rejection. An important difference, however, is that the SVO is not required to and does not justify its Designations by specifically referring to the methodologies upon which it has relied as would be required if it were regulated by the SEC. Also, unlike the NRSROs, the SVO is not subject to examination concerning the methodologies it has used in arriving at its decisions.

Coordination Within the NAIC

Part of the impetus for this proposal for the SVO to assign Designations to assets deemed not to be bonds may be related to work underway by the Statutory Accounting Principles Working Group. It would be wise to coordinate efforts in this regard. A possible result of that project now underway may be to define "bonds" in such a way as to disqualify assets for inclusion on Schedules D and BA when their terms and conditions may appear to make it questionable that the issuer will have resources that are "sufficient" to make all promised payments.

If such debt instruments are placed in "limbo" based on standardized accounting definitions an expected consequence of that would be exactly what is being seen in this proposal: no logical way of determining reasonable RBC factors for the excluded assets. The proposal addresses this in a way but it essentially has the SVO applying Designations to assets that are not bonds. Clearly if this were even desirable the decision to do this would need to be made by the CATF because presently the SVO is only empowered to Designate bonds and preferred stock.

Coordinated efforts might well determine that it would be counterproductive to adopt accounting definitions that would remove debt instruments from the scrutiny of analysts who are using existing methodologies. Presently the determination of whether an issuer is likely to have "sufficient" resources is already being made on an individual basis for each and every bond reported by insurers. An analyst or a team of analysts, whether at the SVO or at an NRSRO, is responsible for determining the likelihood of repayment. These proposals are reviewed internally by committees before being finalized and for NRSROs the SEC requires that historic records be publicly disclosed to document performance. Since this work is already being done for each bond it is not clear what is achieved by adding levels of complexity to definitions. Coordination among NAIC entities should bring these facts to light so they can be adequately considered.

Analysts, whether they may be at the SVO or an NRSRO, could work within a very simple definition of what constitutes a debt instrument and use existing tools already developed to assess

the likelihood of repayment, including "sufficiency" of resources. If this is not being done to levels of accuracy needed to reasonably calculate RBC than that is the matter that should be addressed directly. Adding levels of accounting complexity, however, does not contribute to this process even as it introduces needless complexity and, most likely, unnecessary confusion.

Coordinating the well-intentioned work of SAPWG with other efforts and initiatives, gaining a holistic picture of what is needed to compute RBC as well meeting other needs of insurance regulators, would be very desirable.

Summary

The purpose of NAIC Designations is to enable the computation of RBC to at least a degree of accuracy that will allow regulators to identify weakly capitalized insurers. The NAIC is to be commended for forming the Risk-Based Capital Investment Risk and Evaluation (E) Working Group to coordinate work to continue to make improvements. It is this new group that has the potential for coordinating the efforts of the three NAIC entities to which this proposal relates.[4]

Coordination may very well bring to light that low quality bonds already have low ratings/ Designations -- or none at all -- and this has the same effect as excluding them from definitions. Assuming that they are being done reasonably well the bond-by-bond analyses that are already being performed virtually obviate the necessity for complicated exclusionary definitions. Of course if it is found that sufficiently accurate ratings/Designations are not being generated under the existing structure then that is the issue that must be addressed.

Recommendation

As to this specific proposal it is clearly not desirable for the SVO to apply bond-based RBC factors to assets that the NAIC itself defines as not being bonds. Fortunately the existing rating and Designation procedures can accomplish exactly what the definitional changes are attempting to do but in a much more precise and straightforward way without adding needless complexity. This, in turn, means it should not be necessary for the SVO to Designate assets that have been disqualified definitionally as bonds. This is because poorly supported issues would remain within the existing structure and be judged on their merits using existing methodologies. Specifically, assets with "insufficient" support would be denied bond treatment on a case-by-case basis and not in accordance with generic rules. In fact the current Designation process is being examined by what is being called the *ad hoc* group of this task force so one expects that group will opine on the reliability of NRSRO ratings and NAIC Designations for determining RBC factors and recommend any needed action.

Hopefully the RBC IREWG will be able to coordinate the work of the three relevant NAIC groups to devise effective and efficient procedures that meet the needs of insurance regulators without adding needless complexity and confusion that would be the result of this proposal if it were adopted.

Sincerely,

Copies: Philip Barlow, Denise Genao-Rosado and Charles Therriault

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[4] The Valuation of Securities Task Force, the Statutory Accounting Principles Working Group and the Capital Adequacy Task Force (and its subsidiary entities)

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: Part Four Manual Updates

DATE: February 25, 2022

Summary: With the adoption of new Risk Based Capital factors for each NAIC Designation Category in 2021 by the Capital Adequacy (E) Task Force and its parent, the Financial Condition (E) Committee, technical updates are needed in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to reflect a consistent reference to "NAIC Designation Category" and the additional price points needed to determine them.

Recommendation: The Securities Valuation Office (SVO) and Structured Securities Group (SSG) staff recommend adoption of these non-substantive technical updates to the P&P Manual that were discussed at the Task Force's 2021 Summer National Meeting, Sep. 30, and Nov. 17, 2021 interim meetings, and 2022 Spring National Meeting.

PART FOUR
THE NAIC STRUCTURED SECURITIES GROUP

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NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

DEFINITIONS

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- **Price Grids** means and refers to CUSIP-specific price matrices containing ~~six~~ nineteen price breakpoints; i.e., each price corresponding to a specific NAIC Designation and Designation C~~c~~ategory. Each breakpoint on a Price Grid is the price point that tips the NAIC Designation and Designation Category for the RMBS or CMBS CUSIP into the next NAIC Designation and Designation Category (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.

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ANALYTICAL ASSIGNMENTS

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

22. 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 and Designation C~~c~~ategory. The NAIC Designation and Designation Category 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 and Designation Category for a specific non-Legacy Security RMBS or CMBS 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.

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NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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

26. 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 and Designation Category; i.e., each price point, if exceeded, changes the NAIC Designation and Designation Category. 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~~ benchmark rate + Origination spread). Because of the difference in RBC charge, the deliverable is ~~five~~ nineteen values for each RMBS and CMBS security for companies required to maintain an asset valuation reserve (AVR) and ~~five~~ nineteen values for companies not required to maintain an AVR. This is illustrated in the chart below.

NAIC Designation Category	Life		P&C	
	RBC Factor (Pre-Tax)	Midpoint	RBC Factor	Midpoint
1.A	0.158%	0.215%	0.200%	0.300%
1.B	0.271%	0.345%	0.400%	0.500%
1.C	0.419%	0.471%	0.600%	0.700%
1.D	0.523%	0.590%	0.800%	0.900%
1.E	0.657%	0.737%	1.000%	1.150%
1.F	0.816%	0.916%	1.300%	1.400%
1.G	1.016%	1.139%	1.500%	1.650%
2.A	1.261%	1.392%	1.800%	1.950%
2.B	1.523%	1.846%	2.100%	2.300%
2.C	2.168%	2.660%	2.500%	4.000%
3.A	3.151%	3.844%	5.500%	5.750%
3.B	4.537%	5.277%	6.000%	6.300%
3.C	6.017%	6.702%	6.600%	6.850%
4.A	7.386%	8.461%	7.100%	7.400%
4.B	9.535%	10.982%	7.700%	8.200%
4.C	12.428%	14.685%	8.700%	9.250%
5.A	16.942%	20.370%	9.800%	10.350%
5.B	23.798%	26.899%	10.900%	11.450%
5.C	30.000%	30.000%	12.000%	21.000%
6	30.000%		30.000%	

RBC charge / NAIC designation (pre-tax)

P&C	RBC	Midpoint
1	0.3%	0.65%
2	1.0%	1.50%
3	2.0[illegible]	3.25%
4	[illegible]	7.25%
5	[illegible]	20.00%
6	[illegible]	
Life		**Midpoint**
1	[illegible]	0.85%
2	[illegible]	2.95%
3	[illegible]%	7.30%
4	10.0%	16.50%
5	23.0%	26.50%
6	30.0%	

To Be Deleted

27. 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 Designation Category ~~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.

~~NAIC Designation Determined by Modeled Price Ranges~~	~~Mapped NAIC Designation Category~~
~~1~~	~~1.D~~
~~2~~	~~2.B~~
~~3~~	~~3.B~~
~~4~~	~~4.B~~
~~5~~	~~5.B~~
~~6~~	~~6~~

…

NAIC Risk Assessment

32. In determining the NAIC Designation and Designation Category 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

33. To determine the NAIC Designation and Designation Category 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.

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SSG Role and Process

35. 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 and Designation Category will be assigned by the SVO.

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Purpose

36. 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 and Designation Category for the RMBS or CMBS, which they use to derive the RBC applicable for the RMBS or CMBS.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-06-09 - Interim Meeting/04 - Part Four Updates/2022-003.01 Part Four Updates v2.docx

Mike Monahan
Senior Director, Accounting Policy
202-624-2324 t
mikemonahan@acli.com

July 8, 2022

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

Re: Amendment to Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update Part Four for NAIC Designation Category and Additional Price Points – Comments Due July 9, 2022

Dear Ms. Mears,

The undersigned (ACLI, PPIA, NASVA) appreciate the opportunity to comment on the above referenced exposure to update the P&P Manual for NAIC Designation Category and Additional Price Points.

The undersigned support the proposal in the exposure. Sincerely,

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.

acli.com

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.

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey

Tracey Lindsey NASVA

John Petchler

John Petchler
on behalf of PPiA
Board of Directors

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-08-11 - Summer National Meeting/03 - Part Four Updates/ACLI Comment Letter.docx

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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

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

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

RE: Update the Definition of Principal Protected Securities in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (**Revised June 23, 2022**)

DATE: November 11, 2021

Update – At the Spring National Meeting held on Apr. 5, the SVO was directed work with industry on technical modifications to the original proposed language and expose a revised amendment. The SVO met with representatives of the American Council of Life Insurers (ACLI), Private Placements Investors Association (PPiA) and North American Securities Valuation Association (NASVA) on Apr. 29, May 6 and 24, and Jun. 17. The attached revised amendment reflects those discussions.

Summary – In May 2020 the Task Force adopted an amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the "P&P Manual") to include Principal Protected Securities ("PPS") as a new security type ineligible for the filing exempt process. At the time, the types of PPS which the SVO had seen were mixes of a traditional bond or bonds with additional assets that could possess any characteristic. These additional assets, which we called "performance assets," were intended to generate excess return. They included, among other things, derivatives, common stock, commodities and equity indices. The performance assets generally included undisclosed assets and were typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond. In each case, the external credit rating provider (CRP) rating was based solely on the component dedicated to the repayment of principal and ignored the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1

Recently, the SVO received a proposal for a security which posed many of the same risks as a PPS but was structured in a way that it did not cleanly fit the definition in the P&P Manual. In this example, the security was not issued by an SPV holding both the principal protection bond and the performance asset. Rather, the security was the direct obligation of a large financial institution whose obligation it was to pay principal at maturity and a premium based on the performance of a referenced equity index and an index comprised of equities, fixed-income instruments, futures and other financial assets. Though the obligation was solely that of the issuing financial institution, meaning there were no *underlying* bonds or performance assets, the structure posed the same risk of exposure to a performance asset because the amount of the issuer's payment obligation was directly dependent on the performance of the referenced indices. Additionally, unlike a PPS transaction with an underlying bond and performance asset, the likelihood of payment of that performance asset premium, whatever the amount might be, was linked directly to the creditworthiness of the issuer.

As such, the SVO proposes amending the P&P Manual definition of Principal Protected Securities to account for alternate structures which pose similar risks.

Proposed Amendment - The proposed text changes to the definition of Principal Protected Securities is shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2021 P&P Manual format. Text changes in green underline reflect existing guidance that has been moved to improve clarity.

PART ONE

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

. . .

PRINCIPAL PROTECTED SECURITIES

~~*Defined*~~

~~116. Principal Protected Securities (PPS) are a type of security that repackages one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s) but for which the repackaged security generates potential additional returns as described in the detail criteria for PPSs, along with examples, in Part Three of this Manual.~~

Intent

117. Transactions meeting the criteria of a PPS as defined in Part Three of this Manual may possess Other Non-Payment Risks and must be submitted to the SVO for review under its Subscript S authority.

PRINCIPAL PROTECTED SECURITIES

~~(NOTE: This change is effective as of Jan. 1, 2021. PPS acquired prior to Jan. 1,2021 must be filed with the SVO by Jul. 1, 2021.)~~

Definition

313. Principal Protected Securities (PPSs) typically have both a principal protected component and a performance component whose payments originate from, or are determined by, non-fixed income like sources and, therefore, pose the risk of non-fixed income like cashflows. PPS do not include the exclusions listed below in this section.

314. The following transaction examples are included for demonstrative purposes only, to highlight the intent behind the principle-based PPS definition and the core regulatory concern (that there are Other Non-payments Risks associated with PPSs beyond the contractually promised payments that may not be reflected in a CRP rating) but are not intended to encompass all possible PPS variants. Each of these examples meets the definition of a PPS. Any design that circumvents the definition, and related examples, through technical means but which in substance achieves the same ends or poses the same risk, shall be deemed a PPS.

Example Transactions

315. *Example 1 –* PPS~~s are a type of~~ includes any security that repackages one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s) (including principal and, if applicable, interest, make whole payments and fees thereon) that if purchased by an insurance company on a stand-alone basis would be eligible for Filing Exemption, but for which:

- (i)
  - a. the repackaged security structure enables potential returns from the underlying investments in addition to the contractually promised cash flows paid to such repackaged security according to a fixed schedule;

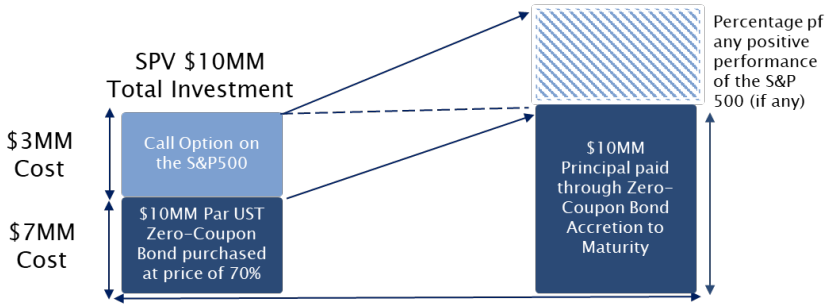
    OR

  - b. the contractual interest rate paid by the PPS is zero, below market or, in any case, equal to or below the comparable risk-free rate;

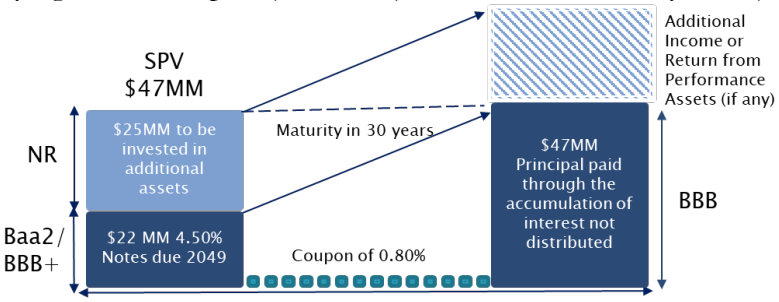
AND

- (ii) the insurer would obtain a more favorable Risk Based Capital charge or regulatory treatment for the PPS through Filing Exemption than it would were it to separately file the underlying investments in accordance with the policies in this Manual.

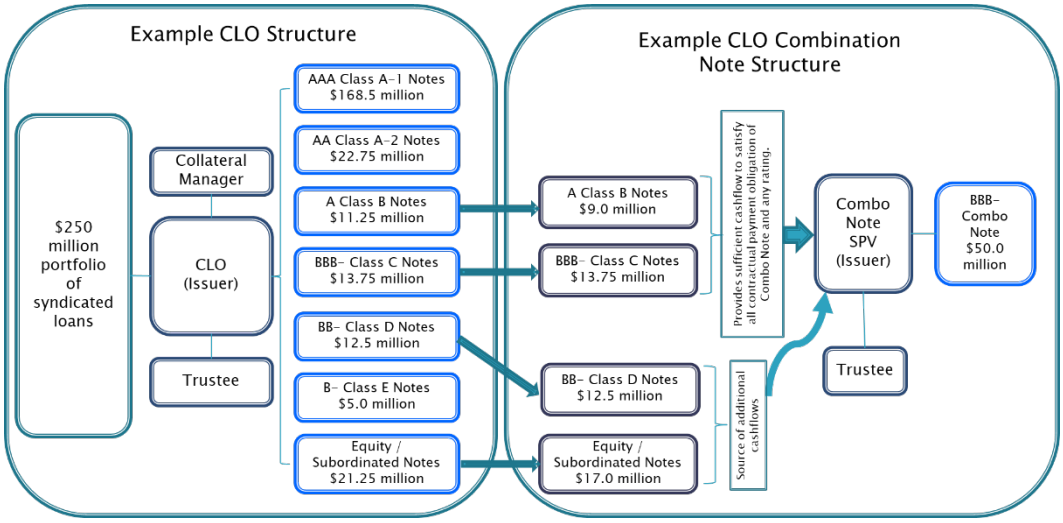
316. *Example 2 –* In this ~~initial~~ example there are only two components: 1) a $10 million par United States Treasury (UST) zero-coupon bond sold at discount (ex. $70) from par ($100) that will pay par ($100) at maturity and 2) a return linked to any positive performance of call options on the S&P 500 Index (if the S&P 500 Index has a negative performance, investors will only receive an amount equal to their initial investment). The CRP rating would be AAA/AA+ or an NAIC 1.A, based solely on the risk of the UST security; whereas, the Weighted Average Ratings Factors (WARF) applied by the SVO would result in an NAIC 4.B when it includes the exposure to the call options on the S&P 500 Index.



317. *Example 3 –* In ~~the second~~ this example there are multiple components: 1) a $22 million corporate bond paying a fixed coupon (ex. 4.50%) with a stated maturity date (ex. 9/30/2049), 2) the corporate bond has two CRP ratings (Moody's Baa2, S&P BBB+), 3) the Special Purpose Vehicle (SPV) also invests $25 million in additional undisclosed and unrated assets, 4) the SPV pays a below market semi-annual coupon of 0.80%, 5) the excess coupon difference (4.50% - 0.80% = 3.70%) is used to accumulate into the required principal to pay at maturity, and 6) a CRP rated the PPS a BBB or NAIC 2.B. , Again, the PPS rating is based solely on the corporate bonds that represent less than 50% of the total investment in this example, whereas, the WARF methodology would result in an NAIC 4.C when the exposure to all of the underlying investments are included.



318. *Example 4 –* This ~~The third~~ example is a repackaging of collateralized loan obligation (CLO) notes into a CLO Combination Note (Combo Note). The initial CLO holds $250 million of syndicated loans and issues $255 million of notes (the CRP rating for each tranche is listed before the Class, ranging from AAA to B-) and Equity / Subordinated Notes. The Combo Note is formed in this example by re-packaging the Class B, C, D, and Equity / Subordinated Note tranches together. The total notional amount of all the



tranches in the Combo Note is $52.25 million. The Combo Note raises proceeds by issuing a single $50 million notional tranche of debt through an SPV. The cashflows from the Class B and C notes are sufficient to repay the $50 million Combo Note principal and interest, if any; which, may constitute a reclassification of the Class B and C tranche interest to repay principal on the Combo Note. Payments from the underlying investments in the Class D and Equity / Subordinated Note tranches provide returns to the repackaged security in addition to the contractually promised cash flows according to a fixed schedule that are based upon the payments from the Class B and Class C Notes. The Combo Note receives a BBB- rating or NAIC 2.C on the notional of $50 million based upon payments from the Class B and C tranches even though $29.5 million or 57% of the underlying investments are rated BB- or unrated, whereas, the WARF would result in an NAIC 4.B when the exposure to all of the underlying investments are included.

319. *Example 5* – In this example, a financial institution issues notes pursuant to which it is obligated to make (i) fixed quarterly coupon payments which are less than the comparable risk-free rate, (ii) performance payments linked to the performance of referenced equity and futures indices and the net asset value of a basket of undisclosed securities, and (iii) a principal payment at maturity. This example differs from the others in that the issuer is an operating entity and not an SPV with underlying assets. Even though the payment of all amounts is the obligation of the issuing financial institution, the size of the performance payments, if any, is wholly dependent on the performance of non-fixed income like reference assets.

Exclusions

320. For the avoidance of doubt, PPSs shall not include defeased or pre-refunded securities which have separate instructions in this Manual; broadly syndicated securitizations, such as collateralized loan obligations (CLOs) (including middle market CLOs) and asset backed securities (ABS), except as described in the examples in this section; or CLO or ABS issuances held for purposes of risk retention as required by a governing law or regulation.

Filing Requirements

321. Investments in PPSs must be submitted to the SVO for review because they may possess Other Non-Payment Risks that the SVO must assess under its Subscript S authority. If the SVO determines in its judgement that there are not any Other Non-Payment Risks, the SVO will permit the security to benefit from Filing Exemption, if it is otherwise eligible.

322. In addition to *Filing Process and Required Documents* outlined in Part Two of this manual, the following additional information is required for PPSs:

- Disclosure of any Subsidiary, Controlled or Affiliated relationship between the PPS or any of the underlying investments and the insurer; including, how the underlying investments were acquired.
- Prior four quarterly financial statements, if produced, trustee or collateral agent reports from the entity issuing the PPS 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).

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

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

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

RE: Update the Definition of Principal Protected Securities in the Purposes and Procedures Manual of the NAIC Investment Analysis Office

DATE: November 11, 2021

Summary – In May 2020 the Task Force adopted an amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the "P&P Manual") to include Principal Protected Securities ("PPS") as a new security type ineligible for the filing exempt process. At the time, the types of PPS which the SVO had seen were mixes of a traditional bond or bonds with additional assets that could possess any characteristic. These additional assets, which we called "performance assets," were intended to generate excess return. They included, among other things, derivatives, common stock, commodities and equity indices. The performance assets generally included undisclosed assets and were typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond. In each case, the external credit rating provider (CRP) rating was based solely on the component dedicated to the repayment of principal and ignored the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1

Recently, the SVO received a proposal for a security which posed many of the same risks as a PPS but was structured in a way that it did not cleanly fit the definition in the P&P Manual. In this example, the security was not issued by an SPV holding both the principal protection bond and the performance asset. Rather, the security was the direct obligation of a large financial institution whose obligation it was to pay principal at maturity and a premium based on the performance of a referenced equity index and an index comprised of equities, fixed-income instruments, futures and other financial assets. Though the obligation was solely that of the issuing financial institution, meaning there were no *underlying* bonds or performance assets, the structure posed the same risk of exposure to a performance asset because the amount of the issuer's payment obligation was directly dependent on the performance of the referenced indices. Additionally, unlike a PPS transaction with an underlying bond and performance asset, the likelihood of payment of that performance asset premium, whatever the amount might be, was linked directly to the creditworthiness of the issuer.

As such, the SVO proposes amending the P&P Manual definition of Principal Protected Securities to account for alternate structures which pose similar risks.

Proposed Amendment - The proposed text changes to the definition of Principal Protected Securities is shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2021 P&P Manual format.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

PRINCIPAL PROTECTED SECURITIES

Definition

312. Principal Protected Securities (PPSs) are a type of security that packages or repackages one or more investment exposures or referenced or underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an issuer obligation or underlying bond(s) (including principal and, if applicable, interest, make whole payments and fees thereon) that if purchased by an insurance company on a stand-alone basis would be eligible for Filing Exemption, but for which:

- (i)
  - a. the ~~repackaged~~ security structure enables potential returns from the investment exposures or referenced or underlying investments in addition to the contractually promised cash flows paid to such ~~repackaged~~ security according to a fixed schedule;

    OR

  - b. the contractual interest rate paid by the PPS is zero, below market or, in any case, equal to or below the comparable risk-free rate;

AND

- (ii) the insurer would obtain a more favorable Risk Based Capital charge or regulatory treatment for the PPS through Filing Exemption than it would were it to separately file the issuer obligation, investment exposures or referenced or underlying investments in accordance with the policies in this Manual.

Mike Monahan
Senior Director, Accounting Policy
202-624-2324 t
mikemonahan@acli.com

February 10, 2022

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

Re: Amendment to the P&P Manual to update the definition of Principal Protected Securities (PPS)

Dear Ms. Mears,

The American Council of Life Insurers ("ACLI"), Private Placement Investors Association ("PPIA"), and North American Securities Valuation Association ("NASVA") ("the undersigned") appreciate the opportunity to engage with state regulators and the NAIC on the SVO's proposed Amendment to the P&P Manual to update the definition of Principal Protected Securities (PPS).

The undersigned support the efforts to the SVO to continue to update the P&P Manual for new developments. The complete reorganization of the P&P Manual, several years ago, was a welcome development in making it more user friendly, and therefore we support continued diligence toward providing clarity as well as minimizing operational challenges for those that need to comply with the provisions of the manual.

While the undersigned agree with the substance behind the proposed amendment, in the spirit of the preceding paragraph, we propose rolling this proposed amendment into the proposed amendment entitled, "Amendment to the P&P Manual to update the definition of Other Non-Payment Risk assigned a Subscript "S" for the following two reasons:

1) PPS securities are a type of Subscript S security. Subscript S securities are already not eligible for filing exemption, and the Subscript S proposed amendment, recommends collectively adding Subscript S securities to the list of non-filing exempt securities (because they were inadvertently left off the list due to a historical oversight). Therefore, we recommend including PPS, as one the illustrations listed under Subscript S, and removing it as a stand-alone example on the list of non-filing exempt securities in a similar manner as with other Subscript S illustrations. Such consistency will improve the clarity and usability of the P&P Manual.
2) While the undersigned supported the SVO's effort to included PPS as a non-filing exempt security, it took several iterations and meetings with the SVO to arrive at a definition that proved workable. By trying to layer in this additional concern, to the PPS definition, we believe a similar effort and dialogue would be needed. Further, it appears some of the additional recommended illustrations in the Subscript S proposed amendment, appear to be attempting to address the same concern. Including that concern in one spot will improve the clarity and usability of the P&P Manual.

We discussed these concepts with Charles Therriault, and his team, and suggested we would like to work with the SVO to address this matter in the most efficient way possible. Our understanding is Charles and team are amenable to this suggestion. Please see our additional letter in response to the Proposed Amendment to the P&P Manual to update the definition of Other Non-Payment Risk assigned a Subscript "S".

We look forward to working with the SVO and regulators on this issue.

Sincerely,

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey

Tracey Lindsey
NASVA

John Petchler

John Petchler
on behalf of PPiA
Board of Directors

Mike Monahan
Senior Director, Accounting Policy
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July 28, 2022

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

Re: Amendment to Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update the Definition of Principal Protected Securities in the Purposes and Procedures Manual of the NAIC Investment Analysis Office

Dear Ms. Mears,

The undersigned (ACLI, PPIA, NASVA) appreciate the opportunity to comment on the above referenced exposure to update the definition of Principal Protected Securities in the Purposes and Procedures Manual of the NAIC Investment Analysis Office.

The undersigned support the proposal in the exposure. Sincerely,

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

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey

Tracey Lindsey
NASVA

John Petchler

John Petchler
on behalf of PPiA
Board of Directors

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-08-11 - Summer NM/04 - Update Definition PPS/2021-048.04 ACLI Comment Letter_VOSTF_Update_Def_PPS_v072822.docx

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

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

FROM: Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group
Kevin Clark, Co-Vice-Chair of the Statutory Accounting Principles (E) Working Group

DATE: 6/10/2022

RE: SAPWG Adoption of the Related Party Reporting Agenda Item

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The purpose of this referral is to notify the Valuation of Securities (E) Task Force that on May 24, 2022, the Statutory Accounting Principles (E) Working Group adopted agenda item *2021-21: Related Party Reporting*, and accordingly the Working Group recommends that the Task Force assess whether edits are needed to the *Practices and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) related to comments raised regarding filing exemption for affiliated structured securities with unaffiliated underlying credit exposure.

For background, agenda item 2021-21 was in response to recent discussions on the reporting and disclosure requirements for investments that involve related parties. This item resulted with revisions to both *SSAP No. 25—Affiliates and Other Related Parties* and *SSAP No. 43R—Loan-Backed and Structured Securities* to clarify guidance, although there were no revisions to the definition of an affiliate or the definition of control. The main intent of the agenda item was to sponsor new reporting information for investments that involve a related party (e.g. as sponsor or originator, etc), regardless of whether the investment is captured on the affiliate reporting line. Because the definition of affiliation is determined by an evaluation of control of the issuer (typically a special purpose entity (SPE) for structured securities), it is possible for an investment that involves an affiliate or related party to not be considered affiliated, while it is also possible for an affiliated debt investment to lack underlying affiliated credit exposure. The adopted reporting changes provide more granular disclosure of the differing types of related party involvement in investment transactions. These reporting changes have also been adopted by the Blanks (E) Working Group and are effective for year-end 2022 statutory financial statements.

During the discussion of this agenda item, comments from industry indicated that many insurers have adopted a practice for structured securities that the Working Group concluded is not consistent with the requirements of SSAP No. 25 or the *Insurance Holding Company System Regulatory Act* (Model #440). That is, rather than determine affiliation based on an evaluation of control of the issuer (the SPE), these insurers have determined affiliation based solely on whether the underlying collateral exposure was affiliated. In some cases, insurers have identified the issuing SPE as an affiliate in Schedule Y, while not reporting the investments issued by those affiliates as affiliated investments on Schedule D. The Working Group concluded that there is no basis in the existing

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statutory accounting principles for this reporting conclusion and adopted the proposed edits which remove any perceived ambiguity.

Upon further discussion of this item, interested parties also noted that there is a presumption that affiliated investments are required to be reviewed by the NAIC Securities and Valuation Office (SVO), and if certain investments previously reported as unaffiliated are now required to be reported as affiliated, they could lose their filing exempt (FE) status. Accordingly, 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 qualify for FE status. As a result, the working group recommended a referral to the Task Force to evaluate any needed updates to the P&P Manual pertaining to this matter.

The Working Group appreciates your time and looks forward to your response. If you have any questions, please contact Dale Bruggeman, or Kevin Clark, SAPWG Chair and Vice Chair, with any questions.

Cc: Julie Gann, Robin Marcotte, Jim Pinegar, Jake Stultz, Jason Farr, Charles Therriault, Marc Pearlman
Attachments: Ref # 2021 adopted revisions, May 24 SAPWG minutes

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/Stat Acctg_Statutory_Referrals/2022/SAPWG to VOSTF - Related Party.docx

Draft: 5/27/22

Statutory Accounting Principles (E) Working Group
Virtual Meeting
May 24, 2022

The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force met May 24, 2022. The following Working Group members participated: Dale Bruggeman, Chair (OH); Kevin Clark and Carrie Mears, Co-Vice Chairs (IA); Sheila Travis (AL); Kim Hudson (CA); Michael Estabrook (CT); Rylynn Brown and Tom Hudson (DE); Eric Moser (IL); Judy Weaver (MI); Doug Bartlett and Pat Gosselin (NH); Bob Kasinow (NY); Melissa Greiner (PA); Jamie Walker and Shawn Frederick (TX); David Smith (VA); and Amy Malm (WI).

1. Reviewed Comments on Exposed Items

The Working Group held a public hearing to review comments (Attachment 1) on previously exposed items.

a. Agenda Item 2022-03

Mr. Bruggeman directed the Working Group to agenda item 2022-03: Premium Adjustment Allocated to Jurisdictions. Robin Marcotte (NAIC) stated that while this agenda item does not propose statutory revisions, it proposes blanks instructional changes to Schedule T, the State Page, and the Accident and Health Policy Experience Exhibit (AHPEE) to clarify guidance for premium adjustments. She stated that NAIC staff received inquiries regarding a minor number of entities that primarily wrote health business related to the federal Affordable Care Act (ACA), who did not properly allocate premium adjustments by jurisdiction but instead reported the adjustments on the "aggregate other alien line" in the statutory financial statements. The proposed instruction changes clarify that all premium adjustments, both increases and decreases, including but not limited to, ACA premium adjustments related to the risk adjustment program, shall be allocated as premium in the respective jurisdiction and are effective for year-end 2022 reporting.

Ms. Malm made a motion, seconded by Mr. Hudson, to adopt agenda item 2022-03 (Attachment 2), noting that the agenda item did not result in statutory revisions; however, it expressed support for the sponsored Blanks (E) Working Group proposal 2022-10BWG. The motion passed unanimously.

b. Agenda Item 2022-08

Mr. Bruggeman directed the Statutory Accounting Principles (E) Working Group to agenda item 2022-08: Treatment of Freddie Mac WI Certificates and the related *Interpretation (INT) 22-01T: Freddie Mac When-Issued K-Deal (WI Trust) Certificates*. Julie Gann (NAIC) stated that this sponsored agenda item is to address the accounting and reporting for Freddie Mac When-Issued K-Deal (WI Trust) Certificates. This program, in essence, creates an additional trust where the investor buys certificates in the WI trust, which is initially backed by cash; and within 90 days, the WI trust uses the cash to purchase the mortgage securities from the real estate mortgage investment conduit trust. Ms. Gann stated that although there is a short delay in acquiring the mortgage-backed securities, the performance of the investment is guaranteed by Freddie Mac. The tentative statutory accounting interpretation clarifies that investments in the Freddie Mac WI Program shall be captured in scope of *Statement of Statutory Accounting Principles (SSAP) No. 43R—Loan-Backed and Structured Securities* from initial acquisition.

Mr. Hudson made a motion, seconded by Ms. Greiner, to adopt the exposed INT 22-01 to clarify that Freddie Mac When-Issued K-Deal (WI Trust) Certificates are in scope of SSAP No. 43R from acquisition (Attachments 3 and 4). The motion passed unanimously.

c. Agenda Item 2021-21

Mr. Bruggeman directed the Working Group to agenda item 2021-21: Related Party Reporting. Jake Stultz (NAIC) stated that this agenda item was drafted in response to recent discussions on the reporting and disclosure requirements for investments that involve related parties. He stated that the agenda item proposes revisions to *SSAP No. 25—Affiliates and Other Related Parties* and SSAP No. 43R, clarifying related party and affiliate guidance, as well as requiring new reporting information for investments that are acquired from a related party, regardless of whether the investment is captured on the affiliate reporting line. He stated that the main goals are to: 1) clarify the reporting of affiliate transactions within existing reporting lines in the investment schedules; and 2) incorporate new reporting requirements for investment transactions with related parties using new reporting codes. He stated that interested parties requested the deletion of a proposed addition to SSAP No. 43R; i.e., an addition that seeks to clarify that investments with arrangements that result in a direct or indirect control shall be reported as affiliated. He stated that in response to these comments, pursuant to existing guidance in the *Insurance Holding Company System Regulatory Act* (#440) and SSAP No. 25, affiliation is determined through direct or indirect control, and that control can be based on voting rights, management and policies, contract, or otherwise. He also stated that the addition to SSAP No. 43R does not modify the current affiliation designation process. He stated that NAIC support staff recommended retaining the sentence requested for deletion; however, they modified it slightly to clarify that these scenarios are examples and not limitations in the determination of control. He stated that NAIC staff recommended that the Working Group adopt this agenda item and confirm that:

1. The new disclosures are effective for year-end 2022 reporting, as this date is in line with other state insurance regulators' initiatives, including the Macroprudential (E) Working Group.
2. The related party new electronic code column is effective for all noted investment schedules: B–Mortgage Loans, D–Long-Term Bonds, DB–Derivatives, BA–Other Long-Term Invested Assets, DA–Short-Term Investments, E2–Cash Equivalents, and DL–Securities Lending Collateral Assets.
3. The related party new electronic code column shall be completed for all investments on any reporting line.
4. The Statutory Accounting Principles (E) Working Group supports the inclusion of Code 6 (no related party relationship), as exposed by the Blanks (E) Working Group (2021-22 BWG), to eliminate potential confusion on whether the absence of a code represents incomplete reporting or a non-related party relationship.

Mr. Stultz stated that information contained in the interested parties' comment letter regarding the determination of affiliation under Model #440, and that it is solely based on voting rights of an equity holder, is incorrect. He stated that although ownership of 10% of voting securities results in a presumption of control, voting securities are not the sole basis for determining control. Determination of the affiliation of an investment is based on an evaluation of control of the investee, whether through voting interests or other means; accordingly, this agenda item does not propose to change the affiliate determination or definition. Mr. Stultz stated that interested parties also recommended other revisions to SSAP No. 25 and *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* to include open-ended foreign regulated investments that are currently captured in *SSAP No. 30R—Unaffiliated Common Stock*; however, it was recommended that any other changes to the exposed language be considered in a separate agenda item.

Angelica Tamayo-Sanchez (New York Life), representing interested parties, stated that there remain interpretation questions regarding the objectives of the agenda item versus what reporting will result upon adoption. She stated that while interested parties agree that guidance states that control can be achieved through means other than ownership, specific questions remain regarding collateral loan obligations (CLOs). She stated that language being proposed for adoption implies that CLOs managed by an affiliated party would be deemed to be an affiliated transaction; i.e., an interpretation that differs from industry's interpretation of current reporting requirements.

She stated that most insurance companies would not have reported CLOs as affiliated investments if the underlying investments do not have affiliated credit exposure, despite it being managed or originated by a related party. She stated that while the agenda item states that it is not intended to change current affiliated reporting requirements, if these investments should be deemed affiliated, most insurers have likely misinterpreted the guidance regarding their reporting. Discussions among industry indicate that if it is the will of the Statutory Accounting Principles (E) Working Group to classify these investments as affiliated, it will be a change from current, prevalent practice. In addition, there is a presumption that affiliated investments are required to be reviewed by the NAIC Securities Valuation Office (SVO), and if certain CLOs are required to be reported as affiliated, they could lose their filing exempt (FE) status. If FE status is lost, the SVO may need to develop additional procedures, as it does not currently have a methodology to designate this type of asset-backed security investment structure.

Mr. Clark stated that there is a mistaken interpretation that affiliation designation based on securitizations should be based on the affiliated credit exposure of the underlying collateral. He stated this interpretation is not consistent with Model #440 or SSAP No. 25. The affiliate designation is determined based on the ability to direct activities, not credit exposure. If an entity can control the activities of another entity, then all transactions, regardless of credit exposure, should be deemed affiliated. Mr. Clark stated that there is nothing in Model #440 that would scope out securitizations, and to exclude them for any purpose, including through the insertion of an unaffiliated intermediatory, is incorrect. He stated that investments without an affiliated credit exposure that are originated or managed through an affiliated entity should be deemed affiliated. The need to distinguish between affiliated and unaffiliated credit exposure, despite being on an affiliated reporting line, is an important goal of this agenda item and is achieved through the new, supplemental reporting codes. Currently, since affiliation is based on control, without the use of these reporting codes, there is no way to differentiate between various types of credit exposure. In addition, some investments could be structured in a manner that the control threshold is not met, thus an investment would not be classified as affiliated; however, it does have underlying affiliated investment involvement; i.e., affiliated origination. This agenda item would assist state insurance regulators in the identification of such circumstances. Mr. Clark stated that the specificity proposed for SSAP No. 25 does not imply that any affiliated involvement causes an investment to become affiliated; it only clarifies that a control evaluation is still required by the insurer. He stated that as an example, for affiliated investment managers who originate investments that are ultimately determined not to be affiliated, the fee structure is certainly an affiliated transaction and should have been reviewed by the state of domicile through an appropriate Model #440 filing. He stated that he would support a referral to the Valuation of Securities (E) Task Force to address FE questions regarding CLOs, as the intent was not to modify FE status of these investments.

Keith Bell (Travelers), representing interested parties, stated that the language as proposed will likely not yield the results desired by state insurance regulators, specifically the reporting of certain investments as affiliated if they are managed by an affiliated asset manager. He stated that Model #440 was drafted prior to the prevalence of securitizations, and the emphasis of the model is on equity investments, not debt investments. He stated that debt investments are the rights to contractual cashflows, which do not represent equity investments; thus, determining control based on a debt investment for the determination of affiliate classification is not consistent with current practice. He stated that interested parties do not disagree with the objectives of state insurance regulators, but they believe the added language changes the scope of affiliated transactions, and if that is the ultimate wish of state insurance regulators, alternate guidance should be considered. Mr. Bruggeman stated that the spirit of the model is that if the underlying entity is affiliated, all associated transactions should also be deemed affiliated. However, increased reporting granularity of underlying credit exposure would be achieved through the new proposed reporting codes. The proposed language is only to clarify control, and it is not modifying Model #440, nor modifying affiliated reporting requirements. Mr. Clark stated that he agrees with Mr. Bruggeman in that if a company is deemed to be affiliated, all transactions, debt, equity, or other should also be reported as affiliated transactions. He also stated that the proposed language only clarifies when control exists, not necessarily how to determine if control exists. He stated that if there is a desire to further clarify how to determine control, that

would need to be in a project separate from this agenda item. Ms. Weaver stated that the interpretive disconnect of industry could leave open the possibility of other investments to not be reported as affiliated, and she inquired if interested parties have suggestions to the proposed revisions. Mr. Bell stated that interested parties do not have any suggestions but believe the current language is not sufficient to meet the needs of state insurance regulators, as there will still be ambiguity in reporting requirements. Rose Albrizio (Equitable), representing interested parties, stated that she concurs with Mr. Bell, and there will be difficulty for industry with applying the clarified affiliated reporting standard.

In response to Mr. Clark's comments regarding determination of control for consolidated reporting purposes, Ms. Tamayo-Sanchez stated that U.S. generally accepted accounting principles (GAAP) generally require the determination of who controls the significant activities or economics in the initial determination of control for consolidated reporting purposes. She stated that if U.S. GAAP were used as a basis to determine if a CLO should be reported as affiliated due to exercising control, they would likely not be deemed as affiliates; however, industry struggles with how to define control of these instruments for statutory reporting purposes. As the insurer likely has a very passive involvement in the underlying investment and is only involved in the investment in the event of certain default situations, an affiliated designation for statutory accounting purposes is not consistent with current processes. Accordingly, many insurers will likely need to now move many debt investments to affiliated reporting lines.

Mr. Bruggeman stated that the challenge is that the intent of the agenda item is not to change affiliated reporting requirements; however, as many insurers believe this is a change, this likely represents an interpretation disconnect between insurers and state insurance regulators. He stated that this agenda will likely: 1) communicate the scope of affiliation determination and the associated reporting desires of state insurance regulators; and 2) supplement the reporting of all investments with the proposed reporting codes. The agenda item is not changing related party or affiliation determination pursuant to Model #440, especially as some states have adopted slight variations to the model. Mr. Clark stated that he agrees with Mr. Bruggeman, and he added that the determination of control has not changed. If detailed guidance regarding the evaluation of control were desired, it should be considered in a separate agenda item; however, insurers should continue to consult with their domestic regulators in the determination of affiliation designation. Mr. Bell stated that Mr. Bruggeman's summation of the challenge was accurate; however, many in industry would not report affiliated debt investments as affiliated transactions, as they interpret Model #440 to be limited to equity interests. He stated that the interpretation of state insurance regulators is that investments originated through, or debt issued by, an affiliated entity is an approach not commonly interpreted by industry. Mr. Clark stated that his interpretation is that if an entity is determined to be affiliated, all transactions—i.e., debt or equity issued by an affiliate—would also be classified as affiliated; and to the extent that this has not been done previously, he supports corrected reporting going forward. Ms. Tamayo-Sanchez stated that the interpretation of industry based on today's discussion was wrong, as they believe Model #440 only requires affiliated reporting if the investment has underlying affiliated credit exposure or if the insurer has control in the underlying investment, not an asset manager who originates the investment. Ms. Albrizio stated that the guidance should be supplemented using examples to clarify which investments should be reported as affiliated, as interested parties do not believe the current guidance is adequate to ensure that the reporting desired by state insurance regulators will be achieved. Mr. Bruggeman stated he appreciates the comments of industry to help articulate the interpretation differences; however, state insurance regulators believe that if an entity is deemed to be affiliated, all investments—debt or equity—should be reported as affiliated, regardless of underlying affiliated credit exposure. With the agenda item, the investments would have supplemental reporting to help further differentiate those with varying degrees of underlying related party credit exposure. Ms. Tamayo-Sanchez, not speaking on behalf of interested parties, stated that the interpretation of applying the affiliated designation to debt instruments only when there was an underlying affiliated credit exposure was incorrect and not in line with state insurance regulator expectations. She stated that for insurers who have not been a party to

the discussions related to this agenda item, they would likely continue existing practices for the determination of affiliation designation.

Mr. Clark made a motion, seconded by Mr. Smith, to:

1. Adopt the exposed revisions in SSAP No. 25; exposed revisions, with minor edits, in SSAP No. 43R; and new reporting disclosures for investments acquired from a related party, regardless of whether the investment is captured on an "affiliate" reporting line (Attachment 5).
2. Confirm that the new reporting codes applicable for investment schedules B, D, DB, BA, DA, E2, and DL shall apply to all investments on any reporting line and are effective for year-end 2022 reporting.
3. Confirm support for the inclusion of Code 6 (no related party relationship), as exposed by the Blanks (E) Working Group (2021-22 BWG) to eliminate potential confusion on whether the absence of a code represents incomplete reporting or a non-related party relationship.
4. Direct NAIC staff to draft the following for future Statutory Accounting Principles (E) Working Group discussion: 1) possible footnote revisions pursuant to interested parties' comments; and 2) examples for possible inclusion in SSAP No. 43R to further clarify investments that should be classified as affiliated.
5. Send a referral to the Valuation of Securities (E) Task Force, notifying of this adopted agenda item, and assess whether corresponding edits are needed to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) regarding CLO investments that may now be classified as affiliated.

The motion passed unanimously.

Ms. Gann stated that as a reminder, the Blanks (E) Working Group has a public call scheduled for May 25, and the Statutory Accounting Principles (E) Working Group has a public call scheduled for July 18 to hear comments on the exposed bond definition and related issue paper.

Having no further business, the Statutory Accounting Principles (E) Working Group adjourned.

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Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Related Party Reporting

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue: This agenda item has been drafted in response to recent discussions on the reporting and disclosure requirements for investments with related parties. This agenda item intends to encompass two main goals:

1. Clarify the reporting of affiliate transactions within existing reporting lines in the investment schedules. This clarification intends to be consistent with the definition of an "affiliate" pursuant to the *Insurance Holding Company System Regulatory Act* (Model #440), *SSAP No. 25—Affiliates and Other Related Parties* and *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*.

2. Incorporate new reporting requirements for investment transactions with related parties. Pursuant to recent discussions, regulators desire additional information on investment transactions involving related parties, regardless of whether the related party is "affiliated" pursuant to Model #440. To preserve the affiliate definition and reporting categories, these additional proposed reporting elements will be captured outside of the current affiliate reporting requirements.

Affiliate Definition and Identified Reporting Issues:

The *Insurance Holding Company System Regulatory Act* (Model #440) defines "affiliate" and "control" as:

- Affiliate: An "affiliate" of, or person "affiliated" with, a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

- Control: The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or nonmanagement services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10%) or more of the voting securities of any other person. This presumption may be rebutted by a showing made in the manner provided by Section 4K that control does not exist in fact. The commissioner may determine, after furnishing all persons in interest notice and opportunity to be heard and making specific findings of fact to support the determination, that control exists in fact, notwithstanding the absence of a presumption to that effect.

The guidance / concepts from Model #440 are reflected in SSAP No. 25, paragraphs 5-7 and SSAP No. 97, paragraphs 5-7 and are summarized as follows:

- An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships,

joint ventures, and limited liability companies as defined in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

- Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

- Control shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18*. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

    1. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.

    2. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

    3. An entity where the insurer has given up participation rights as a shareholder to the investee.

The Annual Statement Instructions identifies what is captured in the reporting lines for "Parent, Subsidiary and Affiliates" as "Defined by *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities."*

Under the existing guidance, the following investments would likely not be reported as affiliated unless a domiciliary state has directed otherwise:

- Qualifying affiliated investments for which the domiciliary state has approved a disclaimer of affiliation or disclaimer of control from the affiliated entity. Once a disclaimer has been granted, the qualifying affiliate relationship is no longer considered an affiliate and any investments issued or held from the entity would not be reported as affiliated.

- Investments held from entities that do not qualify as affiliates, even if the entity qualifies as a related party. The determination of an affiliate is based on direct or indirect control. If the control determinants are not met, investments held from related parties are not reported as affiliated.

- Any investments acquired that were sponsored / originated by an affiliate, but the actual investment is not in the affiliate or other companies within the controlled holding company structure.

Model #440 explicitly excludes the purchase of securities solely for investment purposes from the determination of a change in control, so long as the securities are not used by voting or otherwise to cause or attempt to cause the

substantial lessening of competition in any insurance market in the state. This guidance further states that if the purchase of securities results in a presumption of control, then the acquisition of securities would not be considered solely for investment purposes unless the commissioner of the insurer's state of domicile accepts a disclaimer of control of affirmatively finds that control does not exist.

Proposed Related Party Revisions

Although the affiliate definition may preclude certain investments from being captured in the "affiliated" reporting lines, there is a regulator desire to have improved information on investments with non-affiliated related parties as well as investments acquired from affiliates and non-affiliated related parties that do not reflect an investment within the affiliate/related party. For example, if the affiliate/related party was to sponsor or originate the investment, such investment would likely not be captured in the designated affiliate reported lines. This agenda item proposes revisions to SSAP No. 25 and SSAP No. 43R, as well as proposed concepts for an annual statement reporting change to capture information on these investments. Additionally, the proposed revisions would provide clarity, consistent with the existing affiliate definition, on scenarios that would qualify as affiliated transactions.

As an additional item, the existing reference in SSAP No. 25 to *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18* (FIN 35) has been proposed to be removed. Although the intent was to originally update the U.S. GAAP reference to reflect the current Accounting Standards Codification (ASC) citations, it was noted that the original provisions in FIN 35 (captured now in ASC 323-10-15-8, 323-10-15-10 and 323-10-15-11) only reiterate that the presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies based on ownership of voting stock stands until overcome by prominent evidence to the contrary. The ASC includes the following indicators originally in FIN 35 for when investors would be unable to exercise significant influence over the operating and financial policies of an investee:

- Opposition by the investee, such as litigation or complaints to government regulatory authorities, challenges the investor's ability to exercise significant influence.
- The investor and investee sign an agreement (such as a standstill agreement) under which the investor surrenders significant rights as a shareholder.
- Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regards to the views of the investor.
- The investor wants or needs more financial information to apply the equity method than is available to the investee's other shareholders, tries to obtain that information, and fails. (The ASC example is a request for quarterly info when the investee only provides public information annually.)
- The investor tries and fails to obtain representation on the investee's board of directors.

The ASC also notes that these situations are just indicators and are not all-inclusive and that none of the individual circumstances are necessarily conclusive that the investee is unable to exercise significant influence over the investee's operating and financial policies. Rather, if any of these situations exist, an investor with controlling voting ownership shall evaluate all facts and circumstances related to the investment to reach a judgment about whether the presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies is overcome. Furthermore, the guidance indicates that it may be necessary to evaluate the facts and circumstances over a period of time before reaching a judgment.

After a review of the ASC / FIN 35 guidance, it is proposed that the reference be deleted from SSAP No. 25. The general concepts for a review of all facts and circumstances, as well as example indicators, are already reflected directly in SSAP No. 25. Lastly, the reference to FIN 35 / ASC could be confusing as U.S. GAAP utilizes a different (higher) percentage of voting ownership than statutory accounting.

Existing Authoritative Literature:

- *Insurance Holding Company System Regulatory Act* (Model #440) – This model is an accreditation standard and is adopted by all states in a substantially similar manner. Only the territories of America Samoa, Guam and the Northern Mariana Islands do not have this model adopted.

- *SSAP No. 25—Affiliates and Other Related Parties* establishes statutory accounting principles and disclosure requirements for related party transactions. This statement shall be followed for all related party transactions, even if the transaction is also governed by other statutory accounting principles. As detailed in paragraph 1, related party transactions are subject to abuse as reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny. The guidance in paragraphs 4-8 include the definition of related parties and affiliates:

  4. Related parties are defined as entities that have common interests as a result of ownership, control, affiliation or by contract. Related parties shall include but are not limited to the following:

     a. Affiliates of the reporting entity, as defined in paragraph 5;

     b. Trusts for the benefit of employees, such as pension and profit-sharing trusts and Employee Stock Ownership Plans that are managed by or under the trusteeship of management of the reporting entity, its parent or affiliates;

     c. The principal owners, directors, officers of the reporting entity;

     d. Any immediate family member of a principal owner, director or executive officer of the reporting entity, which means any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, or individual related by blood or marriage whose close association is equivalent to a family relationship of such director, executive officer or nominee for director, or any person (other than a tenant or employee) sharing the household of such director, executive officer or nominee for director;

     e. Companies and entities which share common control, such as principal owners, directors, or officers, including situations where principal owners, directors, or officers have a controlling stake in another reporting entity;

     f. Any direct or indirect ownership greater than 10% of the reporting entity results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation;

     g. The management of the reporting entity, its parent or affiliates (including directors);

     h. Members of the immediate families of principal owners and management of the reporting entity, its parent or affiliates and their management;

     i. Parties with which the reporting entity may deal if either party directly or indirectly controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;

     j. A party which can, directly or indirectly, significantly influence the management or operating policies of the reporting entity, which may include a provider who is contracting with the reporting entity. This is not intended to suggest that all provider contracts create related party relationships;

k. A party which has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests;

l. Attorney-in-fact of a reciprocal reporting entity or any affiliate of the attorney-in-fact; and

m. A U.S. manager of a U.S. Branch or any affiliate of the U.S. manager of a U.S. Branch.

5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. Control as defined in paragraph 6 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.

b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

c. An entity where the insurer has given up participation rights[1] as a shareholder to the investee.

d. Agreements where direct or indirect non-controlling ownership interest is less than 10% where the parties have structured the arrangement in this structure to avoid the 10% threshold in paragraph 4.f. and paragraph 8.

[1] The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: "Protective Rights" and "Substantive Participating Rights" in EITF 96-16, *Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term "participating rights" shall be used consistent with the discussion of substantive participating rights in this EITF.

8. Any direct or indirect ownership interest of the reporting entity greater than 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation. The *Insurance Holding Company System Regulatory Act* (#440) and the *Insurance Holding Company System Model Regulation* (#450) include a provision that allows for the disclaimer of affiliation and/or the disclaimer of control for members of an insurance holding company system. The disclaimer must be filed with the state insurance commissioner. Entities whose relationship is subject to a disclaimer of affiliation or a disclaimer of control are related parties and are subject to the related party disclosures within this statement. Such a disclaimer does not eliminate a "related party" distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

- *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* establishes guidance for these investments. The guidance in this SSAP provides different guidance when there is a "more than minor" or "minor ownership interest." Pursuant to existing guidance, reporting entities must also identify whether the investment is a related-party transaction.

9. Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest[1], shall be reported using an equity method as defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*, paragraphs 8.b.i. through 8.b.iv. (The equity method calculation may result with a negative valuation of the investment; therefore, the SSAP No. 97 equity method calculation shall occur regardless of whether the investment is supported by an audit and the reporting entity will nonadmit the investment.) A reporting entity whose shares of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by SSAP No. 97, paragraph 35.a.

Footnote: With the identification of whether the reporting entity has a minor ownership interest, reporting entities must also identify whether the investment is a related-party transaction. Pursuant to the concepts reflected in *SSAP No. 25—Affiliates and Other Related Parties*, consideration shall be given to the substance of the transaction and the parties whose action or performance materially impacts the insurance reporting entity holding the security. For example, if the underlying assets within a SSAP No. 48 entity represent assets issued by an affiliate, then the SSAP No. 48 entity shall be considered a related party (affiliate) investment, with the transaction subject to the accounting and reporting provisions of SSAP No. 25. As identified in SSAP No. 25, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

- *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* establishes statutory accounting principles for investments in subsidiaries, controlled and affiliated entities. The guidance in paragraphs 3-6 include the definitions for parent, subsidiary, and affiliate. (The definition for an affiliate and control is identical to SSAP No. 25.) (As noted, the Annual Statement reporting lines for "Parent, Subsidiary and Affiliates" refers to the definition within SSAP No. 97. If an investment is held for an entity that does not meet the SSAP No. 97 definitions, or for which a disclaimer of control or affiliation has been received, then the investment would not be captured within the Parent, Subsidiary or Affiliate reporting line.)

3. Parent and subsidiary are defined as follows:

a. Parent—An entity that directly or indirectly owns and controls the reporting entity;

b. Subsidiary—An entity that is, directly or indirectly, owned and controlled by the reporting entity.

4. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint

ventures, and limited liability companies as defined in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments.

5. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity[2].

6. Control as defined in paragraph 5 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18.* The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. An investment in an SCA entity may fall below the level of ownership described in paragraph 5, in which case, the reporting entity would discontinue the use of the equity method, as prescribed in paragraph 13.g. Additionally, through an increase in the level of ownership, a reporting entity may become qualified to use the equity method of accounting (paragraph 8.b.), in which case, the reporting entity shall add the cost of acquiring additional interest to the current basis of the previously held interest and shall apply the equity method prospectively, as of the date the investment becomes qualified for equity method accounting. Examples of situations where the presumption of control may be in doubt include the following:

a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.

b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

c. An entity where the insurer has given up participating rights[3] as a shareholder to the investee.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): In March 2021, the Statutory Accounting Principles (E) Working Group adopted revisions to SSAP No. 25 pursuant to agenda item 2019-34: Related Parties, Disclaimers of Affiliation and Variable Interest Entities. Additionally, a new reporting Schedule Y, Part 3 was adopted by the Blanks (E) Working Group in proposal 2020-37BWG, with an initial

[2] Investments in an exchange traded fund (ETF) or a mutual fund (as defined by the SEC) does not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity (or the holding company group) has of the ETF or mutual fund unless ownership of the ETF actually results in "control" with the power to direct or cause the direction of management of an underlying company. ETFs and mutual funds are comprised of portfolios of securities subject to the regulatory requirements of the federal securities laws. ETFs and mutual funds held by a reporting entity shall be reported as common stock, unless the ETF qualifies for bond or preferred stock treatment per the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. Reporting entities are not required to verify that SCAs (subject to SSAP No. 97) are represented in the portfolio of securities held in ETFs or mutual funds or to adjust the value of SCAs as a result of investments in ETFs or mutual funds.

[3] The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: "Protective Rights" and "Substantive Participating Rights" in *EITF 96-16, Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term "participating rights" shall be used consistent with the discussion of substantive participating rights in this EITF.

effective date of Dec. 31, 2021, to capture information on all entities with ownership greater than 10%, the ultimate controlling parties of those owners and other entities that the ultimate controlling party controls.

The adopted revisions to SSAP No. 25 from agenda item 2019-34 are summarized as follows:

- Clarify the identification of related parties and ensure that any related party identified under U.S. GAAP or SEC reporting requirements would be considered a related party under statutory accounting principles.

- Clarify that non-controlling ownership over 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation.

- Clarify the impact of a disclaimer of control or disclaimer of affiliate under SAP. As detailed, such disclaimers impact holding company group allocation and reporting as an SCA under SSAP No. 97, but do not eliminate the classification as a "related party" and the disclosure of material transactions as required under SSAP No. 25.

- Rejected several U.S. GAAP standards addressing variable interest entities.

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): Not applicable.

Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as a nonsubstantive change, and expose revisions to SSAP No. 25 and SSAP No. 43R to clarify application of the existing affiliate definition as well as to incorporate new disclosure requirements for investments acquired through, or in, related parties, regardless of if they meet the affiliate definition. (Staff Note: Pursuant to the NAIC Policy Statement on Maintenance of Statutory Accounting Principles, new disclosures and modifications to existing disclosures are considered nonsubstantive changes.)

Proposed edits to SSAP No. 25*: (New paragraph 9. Remaining paragraphs would be renumbered.)*

This new paragraph 9 clarifies the application of the existing affiliate and control definitions to limited partnerships, trusts and other special purpose entities when control is held by an affiliated general partner, servicer or other arrangement. (The proposed deletion of FIN 35 is discussed earlier in the agenda item, but is noted as not necessary with the existing statutory accounting guidance.)

5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and

its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. Control as defined in paragraph 6 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.

b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

c. An entity where the insurer has given up participation rights[4] as a shareholder to the investee.

8. Any direct or indirect ownership interest of the reporting entity greater than 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation. The *Insurance Holding Company System Regulatory Act* (#440) and the *Insurance Holding Company System Model Regulation* (#450) include a provision that allows for the disclaimer of affiliation and/or the disclaimer of control for members of an insurance holding company system. The disclaimer must be filed with the state insurance commissioner. Entities whose relationship is subject to a disclaimer of affiliation or a disclaimer of control are related parties and are subject to the related party disclosures within this statement. Such a disclaimer does not eliminate a "related party" distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

9. For entities not controlled by voting interests, such as limited partnerships, trusts and other special purpose entities, control may be held by a general partner, servicer, or by other arrangements. The ability of the reporting entity or its affiliates to direct the management and policies of an entity through such arrangements shall constitute control as defined in paragraph 6. Additionally, a reporting entity or its affiliates may have indirect control of other entities through such arrangements. For example, if a limited partnership were to be controlled by an affiliated general partner, and that limited partnership held greater than 10% of the voting interests of another company, indirect control shall be presumed to exist. If direct or indirect control exists, whether through voting securities, contracts, common management or otherwise, the arrangement is considered affiliated under paragraph 5. Consistent with paragraph 8, a disclaimer of affiliation does not eliminate a "related party" distinction or disclosure requirements for material transactions pursuant to SSAP No. 25

Proposed edits to SSAP No. 43R:

These revisions move the existing guidance in paragraph 4.a. to paragraph 6 and notes the requirement to identify related party investments in the investment schedules. (Note Footnote 5 is just moved to a new paragraph.)

4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor only has

[4] The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: "Protective Rights" and "Substantive Participating Rights" in EITF 96-16, *Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term "participating rights" shall be used consistent with the discussion of substantive participating rights in this EITF.

direct recourse to the issuer's assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

5. Mortgage-referenced securities do not meet the definition of a loan-backed or structured security but are explicitly captured in scope of this statement. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise[6] or by a special purpose trust in a transaction sponsored by a government sponsored enterprise in the form of a "credit risk transfer" in which the issued security is tied to a referenced pool of mortgages and the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage-referenced securities.

6. Investments within the scope of this statement issued by a related party or acquired through a related party transaction or arrangement are also subject to the provisions, admittance assessments and disclosure requirements of SSAP No. 25. In determining whether a security is a related party investment, consideration should be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security. Loan-backed and structured securities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement and SSAP No. 25.

a. Although a loan-backed or structured security may be acquired from a non-related issuer, if the assets held in trust predominantly[8] reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment. In such situations where the underlying collateral assets are issued by related parties that do not qualify as affiliates, these securities shall be identified as related party investments in the investment schedules.

b. A loan-backed or structured security may involve a relationship with a related party but not be considered an affiliated investment. This may be because the relationship does not result in direct or indirect control of the issuer or because there is an approved disclaimer of control or affiliation. Regardless of whether investments involving a related party relationship are captured in the affiliated investment reporting lines, these securities shall be identified as related party investments in the investment schedules. Examples of related party relationships would include involvement of a related party in sponsoring or originating the loan-backed or structured security or any type of underlying servicing arrangement. For the avoidance of doubt, investments from any arrangement that results in direct or indirect control, including control through a servicer or other controlling arrangement, shall be reported as affiliated in accordance with *SSAP No. 25—Affiliates and Other Related Parties*.

[6] Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that either directly issue qualifying mortgage-referenced securities or sponsor transactions in which a special purpose trust issues qualifying mortgage-reference securities. However, this guidance would apply to mortgage-referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of mortgage credit risk.

[8] In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a SSAP No. 43R structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or SSAP No. 43R security issuer. As identified in *SSAP No. 25—Affiliates and Other Related Parties*, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

Proposed Annual Statement Reporting Changes*: (These will be captured in a blanks proposal.)*

These reflect a new electronic-only column for the investment schedules and the related instructions.

Column XX: Investments Involving Related Parties:

Required for all investments involving related parties including, but not limited to, those captured as affiliate investments. This disclosure intends to capture information on investments held that reflect interactions involving related parties, regardless of whether the related party meets the affiliate definition, or the reporting entity has received domiciliary state approval to disclaim control / affiliation.

Enter one of the following codes to identify the role of the related party in the investment.

1. Direct loan or direct investment (excluding securitizations) in a related party, for which the related party represents a direct credit exposure.

2. Securitization or similar investment involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role <u>and for which 50% or more</u> of the underlying collateral represents investments in or direct credit exposure to related parties.

3. Securitization or similar investment involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role and <u>for which less than 50% (including 0%)</u> of the underlying collateral represents investments in or direct credit exposure to related parties.

4. Securitization or similar investment in which the structure reflects an in-substance related party transaction but does <u>not</u> involve a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role.

5. The investment is identified as related party, but the role of the related party represents a different arrangement than the options provided in choices 1-4.

Staff Review Completed by: Julie Gann, NAIC Staff – October 2021

Status:
On December 11, 2021, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 25 and SSAP No. 43R, as illustrated above, to clarify application of the existing affiliate definition and incorporate disclosure requirements for all investments that involve related parties, regardless of if they meet the affiliate definition. In addition, draft annual statement reporting revisions were also exposed, in anticipation of incorporating those revisions into a Blanks (E) Working Group proposal.

On April 4, 2022, the Statutory Accounting Principles (E) Working Group exposed this agenda item, incorporating proposed revisions after considering comments from interested parties shown highlighted in gray below. The changes from the prior exposure only clarify previous components of the proposed revisions. Similar changes to the blanks proposal are also concurrently exposed by the Blanks (E) Working Group in their corresponding agenda item (2021-22BWG) to allow for a year-end 2022 effective date. This item was exposed with a shortened comment period ending May 6.

Proposed edits to SSAP No. 25*: (New paragraph 9. Remaining paragraphs would be renumbered.)*

This new paragraph 9 clarifies the application of the existing affiliate and control definitions to limited partnerships, trusts and other special purpose entities when control is held by an affiliated general partner, servicer

or other arrangement. (The proposed deletion of FIN 35 is discussed earlier in the agenda item, but is noted as not necessary with the existing statutory accounting guidance.)

5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. Control as defined in paragraph 6 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.

b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

c. An entity where the insurer has given up participation rights[9] as a shareholder to the investee.

8. Any direct or indirect ownership interest of the reporting entity greater than 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation. The *Insurance Holding Company System Regulatory Act* (#440) and the *Insurance Holding Company System Model Regulation* (#450) include a provision that allows for the disclaimer of affiliation and/or the disclaimer of control for members of an insurance holding company system. The disclaimer must be filed with the state insurance commissioner. Entities whose relationship is subject to a disclaimer of affiliation or a disclaimer of control are related parties and are subject to the related party disclosures within this statement. Such a disclaimer does not eliminate a "related party" distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

9. For entities not controlled by voting interests, such as limited partnerships, trusts and other special purpose entities, control may be held by a general partner, servicer, or by other arrangements. The ability of the reporting entity or its affiliates to direct the management and policies of an entity through such arrangements shall constitute control as defined in paragraph 6. Additionally, a reporting entity or its

[9] The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: "Protective Rights" and "Substantive Participating Rights" in EITF 96-16, *Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term "participating rights" shall be used consistent with the discussion of substantive participating rights in this EITF.

affiliates may have indirect control of other entities through such arrangements. For example, if a limited partnership were to be controlled by an affiliated general partner, and that limited partnership held greater than 10% of the voting interests of another company[10], indirect control shall be presumed to exist unless the presumption of control can be overcome as detailed in paragraph 7. If direct or indirect control exists, whether through voting securities, contracts, common management or otherwise, the arrangement is considered affiliated under paragraph 5. Consistent with paragraph 8, a disclaimer of affiliation does not eliminate a "related party" distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

Proposed edits to SSAP No. 43R:

These revisions move the existing guidance in paragraph 4.a. to paragraph 6 and notes the requirement to identify related party investments in the investment schedules. (Note Footnote 5 is just moved to a new paragraph.)

4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor only has direct recourse to the issuer's assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

5. Mortgage-referenced securities do not meet the definition of a loan-backed or structured security but are explicitly captured in scope of this statement. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise[12] or by a special purpose trust in a transaction sponsored by a government sponsored enterprise in the form of a "credit risk transfer" in which the issued security is tied to a referenced pool of mortgages and the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage-referenced securities.

6. Investments within the scope of this statement issued by a related party or acquired through a related party transaction or arrangement are also subject to the provisions, admittance assessments and disclosure requirements of SSAP No. 25. In determining whether a security is a related party investment, consideration should be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security. Loan-backed and structured securities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement and SSAP No. 25.

[10] Consistent with SSAP No. 97, footnote 1, investments in an exchange traded fund (ETF) or a mutual fund (as defined by the SEC) does not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity (or the holding company group) has of the ETF or mutual fund unless ownership of the ETF actually results in "control" with the power to direct or cause the direction of management of an underlying company. ETFs and mutual funds are comprised of portfolios of securities subject to the regulatory requirements of the federal securities laws.

[12] Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that either directly issue qualifying mortgage-referenced securities or sponsor transactions in which a special purpose trust issues qualifying mortgage-reference securities. However, this guidance would apply to mortgage-referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of mortgage credit risk.

a. Although a loan-backed or structured security may be acquired from a non-related issuer, if the assets held in trust predominantly[14] reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment. In such situations where the underlying collateral assets are issued by related parties that do not qualify as affiliates, these securities shall be identified as related party investments in the investment schedules.

b. A loan-backed or structured security may involve a relationship with a related party but not be considered an affiliated investment. This may be because the relationship does not result in direct or indirect control of the issuer or because there is an approved disclaimer of control or affiliation. Regardless of whether investments involving a related party relationship are captured in the affiliated investment reporting lines, these securities shall be identified as related party investments in the investment schedules. Examples of related party relationships would include involvement of a related party in sponsoring or originating the loan-backed or structured security or any type of underlying servicing arrangement. For the avoidance of doubt, investments from any arrangement that results in direct or indirect control, including control through a servicer or other controlling arrangement, shall be reported as affiliated in accordance with *SSAP No. 25—Affiliates and Other Related Parties*.

Proposed Annual Statement Reporting Changes*: (These in a blanks proposal 2021-22BWG.)*

These reflect a new electronic-only column for the investment schedules and the related instructions.

Column XX: Investments Involving Related Parties:

Required for all investments involving related parties including, but not limited to, those captured as affiliate investments. This disclosure intends to capture information on investments held that reflect interactions involving related parties, regardless of whether the related party meets the affiliate definition, or the reporting entity has received domiciliary state approval to disclaim control / affiliation.

Enter one of the following codes to identify the role of the related party in the investment.

1. Direct loan or direct investment (excluding securitizations) in a related party, for which the related party represents a direct credit exposure.

2. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role <u>and for which 50% or more</u> of the underlying collateral represents investments in or direct credit exposure to related parties.

3. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role and <u>for which less than 50% (including 0%)</u> of the underlying collateral represents investments in or direct credit exposure to related parties.

[14] In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a SSAP No. 43R structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or SSAP No. 43R security issuer. As identified in *SSAP No. 25—Affiliates and Other Related Parties*, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

4. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies in which the structure reflects an in-substance related party transaction but does not involve a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role.

5. The investment is identified as related party, but the role of the related party represents a different arrangement than the options provided in choices 1-4.

On May 24, 2022, the Statutory Accounting Principles (E) Working Group took the following actions:

1. Adopted, as final, the exposed revisions to SSAP No. 25 and SSAP No. 43R, as illustrated below, to clarify application of the existing affiliate definition and incorporate disclosure requirements for all investments that involve related parties, regardless of if they meet the affiliate definition. The revisions to SSAP No. 43R also included additional minor edits to paragraph 6.b., clarifying that the investments from any arrangements that results in direct or indirect control, which include but are not limited to control through a servicer, shall be reported as affiliated investments.

2. In addition, to the adopted revisions, the Statutory Accounting Principles (E) Working Group expressed support for the corresponding Blanks (E) Working Group proposal (2021-22BWG), which will incorporate 6 reporting codes to identify the role of the related party in any investment, on any reporting line, in schedules: B – Mortgage Loans, D – Long-Term Bonds, DB – Derivatives, BA – Other Long-Term Invested Assets, DA – Short-Term Investments, E2 – Cash Equivalents, and DL – Securities Lending Collateral Assets, with an effective date of December 31, 2022.

3. Direct NAIC staff to draft the following for future Working Group discussion: 1) possible footnote revisions pursuant to interested parties' comments, and 2) examples for possible inclusion in SSAP No. 43R, to further clarify investments that should be classified as affiliated. and

4. Send a referral to the Valuation of Securities (E) Task Force, notifying of this adopted agenda item, and to assess whether corresponding edits are needed to the *Practices and Procedures Manual of the NAIC Investment Analysis Office* regarding CLO investments that may now be classified as affiliated.

Adopted revisions to SSAP No. 25*: (New paragraph 9. Remaining paragraphs would be renumbered.)*

This new paragraph 9 clarifies the application of the existing affiliate and control definitions to limited partnerships, trusts and other special purpose entities when control is held by an affiliated general partner, servicer or other arrangement. (The proposed deletion of FIN 35 is discussed earlier in the agenda item, but is noted as not necessary with the existing statutory accounting guidance.)

5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by

contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. Control as defined in paragraph 6 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.

b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

c. An entity where the insurer has given up participation rights[15] as a shareholder to the investee.

8. Any direct or indirect ownership interest of the reporting entity greater than 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation. The *Insurance Holding Company System Regulatory Act* (#440) and the *Insurance Holding Company System Model Regulation* (#450) include a provision that allows for the disclaimer of affiliation and/or the disclaimer of control for members of an insurance holding company system. The disclaimer must be filed with the state insurance commissioner. Entities whose relationship is subject to a disclaimer of affiliation or a disclaimer of control are related parties and are subject to the related party disclosures within this statement. Such a disclaimer does not eliminate a "related party" distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

9. For entities not controlled by voting interests, such as limited partnerships, trusts and other special purpose entities, control may be held by a general partner, servicer, or by other arrangements. The ability of the reporting entity or its affiliates to direct the management and policies of an entity through such arrangements shall constitute control as defined in paragraph 6. Additionally, a reporting entity or its affiliates may have indirect control of other entities through such arrangements. For example, if a limited partnership were to be controlled by an affiliated general partner, and that limited partnership held greater than 10% of the voting interests of another company[16], indirect control shall be presumed to exist unless the presumption of control can be overcome as detailed in paragraph 7. If direct or indirect control exists, whether through voting securities, contracts, common management or otherwise, the arrangement is considered affiliated under paragraph 5. Consistent with paragraph 8, a disclaimer of affiliation does not eliminate a "related party" distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

[15] The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: "Protective Rights" and "Substantive Participating Rights" in EITF 96-16, *Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term "participating rights" shall be used consistent with the discussion of substantive participating rights in this EITF.

[16] Consistent with SSAP No. 97, footnote 1, investments in an exchange traded fund (ETF) or a mutual fund (as defined by the SEC) does not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity (or the holding company group) has of the ETF or mutual fund unless ownership of the ETF actually results in "control" with the power to direct or cause the direction of management of an underlying company. ETFs and mutual funds are comprised of portfolios of securities subject to the regulatory requirements of the federal securities laws.

Adopted revisions SSAP No. 43R:

These revisions move the existing guidance in paragraph 4.a. to paragraph 6 and notes the requirement to identify related party investments in the investment schedules. (Note Footnote 5 is just moved to a new paragraph.)

4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor only has direct recourse to the issuer's assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

5. Mortgage-referenced securities do not meet the definition of a loan-backed or structured security but are explicitly captured in scope of this statement. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise[18] or by a special purpose trust in a transaction sponsored by a government sponsored enterprise in the form of a "credit risk transfer" in which the issued security is tied to a referenced pool of mortgages and the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage-referenced securities.

6. Investments within the scope of this statement issued by a related party or acquired through a related party transaction or arrangement are also subject to the provisions, admittance assessments and disclosure requirements of SSAP No. 25. In determining whether a security is a related party investment, consideration should be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security. Loan-backed and structured securities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement and SSAP No. 25.

a. Although a loan-backed or structured security may be acquired from a non-related issuer, if the assets held in trust predominantly[20] reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment. In such situations where the underlying collateral assets are issued by related parties that do not qualify as affiliates, these securities shall be identified as related party investments in the investment schedules.

b. A loan-backed or structured security may involve a relationship with a related party but not be considered an affiliated investment. This may be because the relationship does not result in direct or indirect control of the issuer or because there is an approved disclaimer

[18] Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that either directly issue qualifying mortgage-referenced securities or sponsor transactions in which a special purpose trust issues qualifying mortgage-reference securities. However, this guidance would apply to mortgage-referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of mortgage credit risk.

[20] In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a SSAP No. 43R structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or SSAP No. 43R security issuer. As identified in *SSAP No. 25—Affiliates and Other Related Parties*, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

of control or affiliation. Regardless of whether investments involving a related party relationship are captured in the affiliated investment reporting lines, these securities shall be identified as related party investments in the investment schedules. Examples of related party relationships would include involvement of a related party in sponsoring or originating the loan-backed or structured security or any type of underlying servicing arrangement. For the avoidance of doubt, investments from any arrangement that results in direct or indirect control, which include but are not limited to control through a servicer or other controlling arrangement, shall be reported as affiliated in accordance with *SSAP No. 25—Affiliates and Other Related Parties*.

Supported Annual Statement Reporting Changes: (Reflected in 2021-22BWG.)

These reflect a new electronic-only column for the investment schedules and the related instructions.

Column XX: Investments Involving Related Parties:

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2. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role <u>and for which 50% or more</u> of the underlying collateral represents investments in or direct credit exposure to related parties.

3. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role and <u>for which less than 50% (including 0%)</u> of the underlying collateral represents investments in or direct credit exposure to related parties.

4. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies in which the structure reflects an in-substance related party transaction but does <u>not</u> involve a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role.

5. The investment is identified as related party, but the role of the related party represents a different arrangement than the options provided in choices 1-4.

6. The investment does not involve a related party.

To: Doug Ommen, Commissioner, Valuation of Securities (E) Task Force Chair and

Scott A. White, Commissioner, Valuation of Securities (E) Task Force Vice Chair

From: Marlene Caride, Commissioner, Financial Stability (E) Task Force Chair and

Justin Schrader, Macroprudential (E) Working Group Chair

CC: NAIC Support Staff: Charles A. Therriault

Date: July 21, 2022

Re: Referral from the Plan for the List of MWG Considerations

The NAIC Macroprudential (E) Working Group (MWG) of the Financial Stability (E) Task Force (FSTF) was charged with coordinating the various NAIC activities related to private equity (PE) owned insurers. As an initial step, the MWG developed a list of 13 regulatory considerations. These considerations are frequently referenced as private equity (PE) concerns, but the Working Group developed the list with an activities-based frame of mind, recognizing that any ownership type and/or corporate structure could participate in these activities, including but not limited to PE owned insurers. The MWG members discussed detailed elements of the considerations and potential regulatory work, including explicit reference to the 2013 guidance added to the NAIC Financial Analysis Handbook for Form A reviews when a private equity owner was involved, and interested parties added useful comments to these during an exposure period. The MWG and FSTF adopted a final plan for addressing each of the 13 considerations, including many referrals to other NAIC committee groups.

The Financial Condition E Committee adopted this plan with no changes made during its virtual meeting on July 21, 2022. NAIC staff support drafted this referral letter to accomplish the actions captured in the adopted plan. It is unlikely any further modifications will occur to the adopted plan when it is considered for adoption by the full Plenary, but it is a possibility. Please begin work to address these referrals, recognizing the adoption by Plenary is still outstanding.

Each MWG consideration referred to your group is listed below. The summarized notes from the MWG regulator-only discussions follow the consideration in blue font and any interested party comments are also provided in purple font. Please consider these discussion points and comments in addition to your own discussion ideas when developing proposals to address the MWG consideration.

NAIC staff support for the MWG will follow the work your group performs and summarize your activities for reporting up to the FSTF. If you have any questions or need further direction, please contact Todd Sells (tsells@naic.org).

MWG Consideration Items Referred:

(Consideration 3 has been referred to the Risk-Focused Surveillance (E) Working Group. A copy follows since the Valuation of Securities (E) Task Force (VOSTF) is referenced in the regulator discussion.)

3. The material terms of the IMA and whether they are arm's length or include conflicts of interest –including the amount and types of investment management fees paid by the insurer, the termination provisions (how difficult or costly it would be for the insurer to terminate the IMA) and the degree of discretion or control of the investment manager over investment guidelines, allocation, and decisions.

Regulator discussion results:

- Refer this item to the NAIC Risk-Focused Surveillance (E) Working Group. Regulators recognized similar dynamics to the first two considerations, but this Working Group was selected because it is already currently focused on a project involving affiliated agreements and Form D filings. Items discussed:
    - Consider training and examples, such as unique termination clauses and use of sub-advisors with the potential for additive fees, and strategies to address these.
        - This included addressing pushback on obtaining sub-advisor agreements as Form D disclosures and some optional disclosures for the Form A.
    - Given the increasing prevalence of bespoke agreements, does it make sense to tie this work in to the work of the NAIC Valuation of Securities (E) Task Force and/or the NAIC Securities Valuation Office? If yes, how best to do so?
    - Surplus Notes and appropriate interest rates given their special regulatory treatment, including whether floating rates are appropriate; follow any Statutory Accounting Principles (E) Working Group projects related to this topic and provide comments needed.

Risk & Regulatory Consulting (RRC) Comment: "With respect to an Investment Management Agreement, RRC encourages an approach that includes a thorough review of the IMA to ensure it is fair and reasonable to the insurer. In addition to the specific items noted for consideration:

- ♣ Are there detailed and reasonable investment guidelines?
- ♣ Is there sufficient expertise at the insurer and on the insurer's Board to properly assess the performance and compliance of the investment manager?
- ♣ Is the investment manager registered as such under the Investment Advisers Act of 1940, and recognizes the standard of care as a fiduciary?

AIC Comments on "Conflict of Interest, Fees, and Termination" (3 individual comments):

Conflict of Interest

As a general matter, the terms of a contractual agreement should not be viewed as giving rise to a conflict of interest when the agreement is negotiated on an arm's length basis. Notwithstanding the foregoing, current law provides an established process to address potential conflicts (for example, requirements to appoint independent directors and traditional corporate law processes to ensure fairness and, under certain circumstances, review of transactions by regulators pursuant to Form D filings). Accordingly, investments sourced and allocated by alternative asset managers on behalf of insurance company clients should not, absent other factors, be viewed as presenting a potential conflict of interest, particularly where insurers retain full control over asset allocation (for example, insurers retain control over the asset classes in which they invest, as well as the amounts and periods of time over which such asset exposure is achieved).

Fees

Importantly, as an initial consideration, any fees paid to investment managers cannot be considered in isolation, rather they should be considered on a "net" basis – i.e., on the basis of total return (after fees are taken into account). Sophisticated institutional investors (including insurers) have a successful history of investing in a range of strategies despite certain investment products generally having higher fees than other available investment opportunities. On a net basis, private equity has consistently outperformed more traditional asset classes such as publicly traded stocks and public mutual funds8 Net-of-fees private debt funds have also consistently outperformed bond and equity market benchmarks.9 Insurers continue to recognize the value of investment opportunities that outperform when considered on a net basis.10 This approach has enabled the consistent delivery of industry leading investment results, which ultimately leads to a high level of financial strength.

Termination

Asset managers often dedicate extensive resources at the outset of a new arrangement in support of managing an insurer's general account assets (e.g., dedicating or reassigning existing personnel, hiring new employees, investing in information technology systems, expanding office space, further enhancing compliance and regulatory processes). As such, and because, in our experience, insurers have the right to terminate their investment management agreements (e.g., upon 30 days' notice), the desire for external asset managers to seek contractual protections (subject to arms' length negotiations) should an insurer decide to terminate the arrangement earlier than was originally anticipated by the parties is entirely appropriate.

(Similarly, Consideration 10 has been referred to the Examination Oversight (E) Task Force, but a copy follows since the regulators expressed support for an VOSTF blanks item, determined to forward an RRC comment to the VOSTF, and directed the AIC to follow the VOSTF work related to this Consideration.)

10. 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, and involve a lack of transparency. (The NAIC Capital Markets Bureau continues to monitor this and issue regular reports, but much of the work is complex and time-intensive with a lot of manual research required. The NAIC Securities Valuation Office will begin receiving private rating rationale reports in 2022; these will offer some transparency into these private securities.)
    a. LATF's exposed AG includes disclosure requirements for these risks as well as how the insurer is modeling the risks.
    b. SVO staff have proposed to VOSTF a blanks proposal to add market data fields (e.g., market yields) for private securities. If VOSTF approves, a referral will be made to the Blanks WG.

Regulator discussion results:

- Regulators focused on the need to assess whether the risks of these investments are adequately included in insurers' results and whether the insurer has the appropriate governance and controls for these investments. Regulators discussed the potential need for analysis and examination guidance on these qualifications.
- To assist regulators in identifying concerns in these investments, regulators expressed support for the VOSTF proposal to obtain market yields to allow a comparison with the NAIC Designation. Once such data is available, regulators ask NAIC staff to develop a tool or report to automate this type of initial screening. Also, regulators again recognized the SAPWG Schedule D revamp work will help in identifying other items for initial screening.
- The regulators discussed LATF's exposed AG, noting the Actuarial Memorandum disclosures that would be required for these privately structured securities along with the actuarial review work, and recognizing how those would be useful for analysts and examiners when reviewing these investments. Additionally, the Valuation and Analysis (E) Working Group would be able to serve as a resource for some of these insights for states without in house actuaries.
- As a result of the above discussions, regulators agreed to a referral to the Examination Oversight (E) Task Force to address the disclosures that will be available from LATF's exposed AG. They agreed to wait for any further work or referral until they have an opportunity to work with the results of the VOSTF proposal and the SAPWG Schedule D revamp project.
- Since reserves are not intended to capture tail risk, refer this item to the NAIC RBC Investment Risk and Evaluation (E) Working Group and monitor the Working Group's progress. (Regulators adopted this recommendation from the RRC comment letter.)

RRC Comments on "privately structured securities which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency." (MWG regulators directed this comment be sent to the VOSTF for its existing work related to this Consideration.)

- ♣ While the lack of available public data does present a significant issue and does mean there is in theory a lower degree of liquidity, we caution at being overly concerned about the private nature of such transactions.
    - Any highly structured transaction is going to lack liquidity.

- The NAIC had at one time a disclosure for Structured Notes. This allowed regulators to see when that represented an excessive risk. We encourage the reinstitution of that disclosure.

♣ A potential consideration related to complex asset structures would be to incorporate this risk factor into the criteria for additional liquidity risk analysis outlined in the NAIC 2021 Liquidity Stress Test Framework (Framework). Considering the amount of effort spent on developing the Framework, it may be helpful to leverage its requirements for situations in which significant complex securities are used to back insurer liabilities.

AIC Comment on "Privately Structured Securities" (the comment and its 6 bullets follow) – Regulators asked the AIC to follow the work of the NAIC Examination Oversight (E) Task Force and the NAIC Valuation of Securities (E) Task Force and provide comments on specific recommendations if needed.

Insurers are increasingly seeking the services of alternative asset managers with significant asset origination capabilities and private credit expertise to manage a portion of their assets, which provide a number of benefits to the insurer and their policyholders. Those benefits include:

♣ A natural alignment between the long-dated insurance liabilities and the long-term investment approach taken by alternative asset managers, including in the private credit space;

♣ Alternative asset managers have the ability to source, underwrite and execute private credit transactions that require skill sets, experience, and scale that many insurance companies do not possess in-house;

♣ Private equity and private credit firms also provide an opportunity for smaller and midsized insurers to access these asset classes, which historically have been the primary purview of large insurers that have the scale to afford in-house asset management functions that can originate these assets, making the industry more competitive to the ultimate benefit of policyholders;

♣ Engaging asset managers with differentiated capabilities can be more cost efficient than making significant investments in an internal asset management function. By availing themselves of these advantages, insurers can benefit from cost-effective sourcing and origination capabilities in attractive asset classes, resulting in enhanced long-term adequacy margins for policyholders, increased spread/earnings, and more competitive product pricing that inures to the benefit of policyholders;

♣ Asset-backed security default rates are substantially similar to corporate investment grade debt default rates while CLO default rates are substantially lower than corporate default rates; and

♣ The focus on private investments is belied by the fact that institutions with higher allocations to private investments have outperformed (with less volatility) those with less.

(Consideration 11 is copied below due to the reference to VOSTF work.)

11. The level of reliance on rating agency ratings and their appropriateness for regulatory purposes (e.g., accuracy, consistency, comparability, applicability, interchangeability, and transparency).
    a. VOSTF has previously addressed and will continue to address this issue. A small ad hoc group is forming (key representatives from NAIC staff, 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.

Regulator discussion results:

- Regulators agreed to monitor the work of the ad hoc group in lieu of any specific recommendations at this time. Recognizing this will likely be a multi-year project, regulators reserve the right to raise specific concerns that may arise as the various NAIC committee groups work to address this list of considerations.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-08-11 - Summer NM/06 - MWG Referral/2022-011.01 MWG Referral to VOS TF - July 2022.docx

Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers

-Plan adopted by FSTF/MWG on June 27, 2022

A summary of currently identified regulatory considerations follows with no consideration of priority or importance (green underlined font indicates current or completed work by another NAIC committee group). Most of these considerations are not limited to PE owned insurers and are applicable to any insurers demonstrating the respective activities. A summary of the regulatory process has been added to this document since it is being used by individuals less familiar with the state insurance regulatory system, and the results of regulator discussions on how to move forward have been added to specific considerations in blue font. Interested party comments are included in purple font and are followed by the regulators' decision on how to address the comments.

State insurance regulators monitor the solvency of each legal entity insurer, including assessing risks from the broader holding company when an insurer is part of a group, making use of routinely required disclosures, both public, such as the statutory financial statements, and confidential, such as the Risk-Based Capital (RBC) supplemental filing and Holding Company form filings. Regulators also use many analysis and examination tools and procedures for each insurer and/or insurance group. Regulatory responses to the analysis and examination work depend upon the results of those reviews. One specific area of solvency monitoring work focuses on potential acquisitions of a US legal entity insurer, involving a Form A filing. In 2013, guidance was added to the NAIC Financial Analysis Handbook for Form A reviews when a private equity owner was involved, although these considerations are not limited to PE acquisitions. The guidance provides examples of stipulations, both limited time and continuing, regulators could use when approving the acquisition to address solvency concerns, as well as for use in ongoing solvency monitoring. Examples follow:

Limited Time Stipulations:

- Requiring RBC to be maintained at a specified amount above company action level/trend test level. Because capital serves as a buffer that insurers use to absorb unexpected losses and financial shocks, this would better protect policyholders.
- Requiring quarterly RBC reports rather than annual reports as otherwise required by state law.
- Prohibiting any dividends, even ordinary.
- Requiring a capital maintenance agreement or prefunded trust account.
- Enhancing the scrutiny of operations, dividends, investments, and reinsurance by requiring material changes in plans of operation to be filed with the commissioner (including revised projections), which, at a minimum, would include affiliated/related party investments, dividends, or reinsurance transactions to be approved prior to such change.
- Requiring a plan to be submitted by the group that allows all affiliated agreements and affiliated investments to be reviewed, despite being below any materiality thresholds otherwise required by state law. A review of agreements between the insurer and affiliated entities may be particularly helpful to verify there are no cost-sharing agreements that are abusive to policyholder funds assessment.

Continuing Stipulations:

- Requiring prior commissioner approval of material arms-length, non-affiliated reinsurance treaties or risk-sharing agreements.
- Requiring notification within 30 days of any change in directors, executive officers or managers, or individuals in similar capacities of controlling entities, and biographical affidavits and such other information as shall reasonably be required by the commissioner.

- Requiring filing of additional information regarding the corporate structure, controlling individuals, and other operations of the company.
- Requiring the filing of any offering memoranda, private placement memoranda, any investor disclosure statements or any other investor solicitation materials that were used related to the acquisition of control or the funding of such acquisition.
- Requiring disclosure of equity holders (both economic and voting) in all intermediate holding companies from the insurance company up to the ultimate controlling person or individual but considering the burden on the acquiring party against the benefit to be received by the disclosure.
- Requiring the filing of audit reports/financial statements of each equity holder of all intermediate holding companies but considering the burden on the acquiring party against the benefit to be received by the disclosure.
- Requiring the filing of personal financial statements for each controlling person or entity of the insurance company and the intermediate holding companies up to the ultimate controlling person or company. Controlling person could include for example, a person who has a management agreement with an intermediate holding company.

Among many other concepts, regulators are considering the need for any additional stipulations, if there are some stipulations that should be required instead of used subjectively, and use of some stipulations beyond the Form A acquisition process (e.g., for insurers acquired in the past).

RRC Comments "In a Form A transaction" (7 bullet points) – These bullet points will be included in the referrals to the NAIC Group Solvency Issues (E) Working Group and the NAIC Risk-Focused Surveillance (E) Working Group for consideration when addressing Consideration numbers 1, 2, 4 and 5.

1. Regulators may not be obtaining clear pictures of risk due to holding companies structuring contractual agreements in a manner to avoid regulatory disclosures and requirements. Additionally, affiliated/related party agreements impacting the insurer's risks may be structured to avoid disclosure (for example, by not including the insurer as a party to the agreement).

   Regulator discussion results:
   - Refer this item to the NAIC Group Solvency Issues (E) Working Group. Items discussed:
     - Instead of requiring for all Form A acquisitions to provide additional disclosures, structure an optional disclosure requirement that can be used when unresolved regulatory concerns exist with the acquisition. For example:
       - Disclosures to allow regulators to assess the goal of the potential owner in acquiring the insurer, how the potential owner will be paid and in what amounts, and the ability of the potential owner to provide capital support as needed.
       - Copies of disclosures provided to the potential owner's investors.
     - Provide training as needed to states with less experience reviewing complex Form A transactions and refer those states to more experienced states for live help.
       - These options include highlighting the need to use external expertise for complex transactions, especially to understand non-U.S. affiliations and when assessing multiple complex Form A applications, and at the expense of the Form A applicant.

AIC Comment (recommended 2 items) – These two items will be included in the referral to the NAIC Group Solvency Issues (E) Working Group for its work on Consideration #1.

- Recommendation: The Working Group should assess, among other items: (i) the need to provide regulatory certainty *vis a vis* when and on what basis additional disclosures could be required; and (ii) whether the additional disclosures would extend approval timelines. We believe such items are critical to insurers being able to access the capital markets effectively and efficiently.

2. Control is presumed to exist where ownership is >=10%, but control and conflict of interest considerations may exist with less than 10% ownership. For example, a party may exercise a controlling influence over an insurer through Board and management representation or contractual arrangements, including non-customary minority shareholder rights or covenants, investment management agreement (IMA) provisions such as onerous or costly IMA termination provisions, or excessive control or discretion given over the investment strategy and its implementation. Asset-management services may need to be distinguished from ownership when assessing and considering controls and conflicts.

Regulator discussion results:

- Refer this item to the NAIC Group Solvency Issues (E) Working Group. Regulators recognized the integral connection of the first two considerations. Items discussed:
    - An emphasis on training and providing detailed examples to address the complexity and creativity involved in some of these Form A agreements and holding company structures.
    - It is not practical to get copies of operating agreements from every entity in a group to assess control impacts to the insurers. Consider ways of better targeting the pertinent agreements to assess, including a potential list of questions about less than 10% owners for use when considering Form A applications and/or ongoing analysis.
    - Consider if Form B (Insurance Holding Company System Annual Registration Statement) disclosure requirements should be modified to address these considerations.

AIC Comment (2 primary concerns) – Regulators asked the AIC to follow the work of the NAIC Group Solvency Issues (E) Working Group on Consideration #2 and make comments on specific recommendations if needed.

- Concerns: The 10% presumption of control needs to remain; and contractual terms contained in service agreements that are negotiated on an arm's length basis are not sufficient to convey the power to direct or cause the direction of an insurer, so long as they are subject to the ultimate supervision and control by the insurer.

3. The material terms of the IMA and whether they are arm's length or include conflicts of interest —including the amount and types of investment management fees paid by the insurer, the termination provisions (how difficult or costly it would be for the insurer to terminate the IMA) and the degree of discretion or control of the investment manager over investment guidelines, allocation, and decisions.

Regulator discussion results:

- Refer this item to the NAIC Risk-Focused Surveillance (E) Working Group. Regulators recognized similar dynamics to the first two considerations, but this Working Group was selected because it is already currently focused on a project involving affiliated agreements and Form D filings. Items discussed:

- Consider training and examples, such as unique termination clauses and use of sub-advisors with the potential for additive fees, and strategies to address these.
  - This included addressing pushback on obtaining sub-advisor agreements as Form D disclosures and some optional disclosures for the Form A.
- Given the increasing prevalence of bespoke agreements, does it make sense to tie this work in to the work of the NAIC Valuation of Securities (E) Task Force and/or the NAIC Securities Valuation Office? If yes, how best to do so?
- Surplus Notes and appropriate interest rates given their special regulatory treatment, including whether floating rates are appropriate; follow any Statutory Accounting Principles (E) Working Group projects related to this topic and provide comments needed.

RRC Comments "With respect to an Investment Management Agreement (IMA" (3 bullet points) – These bullet points will be included in the referral to the NAIC Risk-Focused Surveillance (E) Working Group for Consideration #3.

AIC Comments on "Conflict of Interest, Fees, Termination" (3 individual comments) – These comments will be included in the referral to the NAIC Risk-Focused Surveillance (E) Working Group for its work on Consideration #3.

4. Owners of insurers, regardless of type and structure, may be focused on short-term results which may not be in alignment with the long-term nature of liabilities in life products. For example, investment management fees, when not fair and reasonable, paid to an affiliate of the owner of an insurer may effectively act as a form of unauthorized dividend in addition to reducing the insurer's overall investment returns. Similarly, owners of insurers may not be willing to transfer capital to a troubled insurer.
   a. Life Actuarial (A) Task Force (LATF) work addresses this – helping to ensure the long-term life liabilities (reserves) and future fees to be paid out of the insurer are supported by appropriately modeled assets.

Regulator discussion results:
- In addition to LATF's work, refer this item to the NAIC Risk-Focused Surveillance (E) Working Group, as it is already looking at some of this work related to affiliated agreements and fees. Items discussed:
  - Capital maintenance agreements, suggesting guidance for the appropriate entities to provide them and considering ways to make them stronger.

5. Operational, governance and market conduct practices being impacted by the different priorities and level of insurance experience possessed by entrants into the insurance market without prior insurance experience, including, but not limited to, PE owners. For example, a reliance on TPAs due to the acquiring firm's lack of expertise may not be sufficient to administer the business. Such practices could lead to lapse, early surrender, and/or exchanges of contracts with in-the-money guarantees and other important policyholder coverage and benefits.
   a. The NAIC Financial Analysis Handbook includes guidance specific to Form A consideration and post approval analysis processes regarding PE owners of insurers (developed previously by the Private Equity Issues (E) Working Group).

Regulator discussion results:

- Regulators considered referring this consideration to the NAIC Risk-Focused Surveillance (E) Working Group but opted to keep developing more specific suggestions for now. Items discussed:
    - Consider optional Form A disclosures and guidance for less experienced states; review EU conduct of business language and consider if similar concepts would help target the optional use.
    - Consider more detailed guidance for financial examinations.
    - Besides just inexperience, the consideration also includes intentional actions that ignore known concerns to achieve owner's results; might need to consider Market Conduct group(s).

6. No uniform or widely accepted definition of PE and challenges in maintaining a complete list of insurers' material relationships with PE firms. (UCAA (National Treatment WG) dealt with some items related to PE.) This definition may not be required as the considerations included in this document are applicable across insurance ownership types.

Regulator discussion results:

- Regulators do not believe a PE definition is needed, as the considerations are activity based and apply beyond PE owners.

7. The lack of identification of related party-originated investments (including structured securities). This may create potential conflicts of interests and excessive and/or hidden fees in the portfolio structure, as assets created and managed by affiliates may include fees at different levels of the value chain. For example, a CLO which is managed or structured by a related party.
    a. An agenda item and blanks proposal are being re-exposed by SAPWG. Desire for 2022 year-end reporting to include disclosures identifying related-party issuance/acquisition.

Regulator discussion results:

- Regulators are comfortable the SAPWG's work is sufficient as a first step since it involves code disclosures to identify various related party issues. They also recognize that existing and/or referred work at the Risk-Focused Surveillance (E) Working Group may address some items in this consideration. Once regulators work with these SAPWG disclosures and other regulatory enhancement, further regulatory guidance may be considered as needed.

8. Though the blanks include affiliated investment disclosures, it is not easy to identify underlying affiliated investments and/or collateral within structured security investments. Additionally, transactions may be excluded from affiliated reporting due to nuanced technicalities. Regulatory disclosures may be required to identify underlying related party investments and/or collateral within structured security investments. This would include, for example, loans in a CLO issued by a corporation owned by a related party.
    a. An agenda item and blanks proposal are being re-exposed by SAPWG. The concept being used for investment schedule disclosures is the use of code indicators to identify the role of the related party in the investment, e.g., a code to identify direct credit exposure as well as codes for relationships in securitizations or similar investments.

Regulator discussion results:

- Like the previous consideration, regulators are looking forward to using these code disclosures

to help target areas for further review. However, specific to CLO/structured security

considerations, regulators support a referral to the Examination Oversight (E) Task Force. Specific items discussed include:

- Since investors in CLOs obtain monthly collateral reports, regulators should consider asking for such reports when concerns exist regarding a company's potential exposure to affiliated entities within their CLO holdings.
- Regulators would like to have more information regarding the underlying portfolio companies affiliated with a CLO manager to help quantify potential exposure between affiliates and related parties.
- Regulators request NAIC staff to consider their ability to provide tools and/or reports to help regulators target CLOs/structured securities to consider more closely.

RRC Comments on "collateralized loan obligations (CLOs)" (2 bullet points) – These bullet points will be included in the referrals to the NAIC Examination Oversight (E) Task Force and the NAIC Risk-Focused Surveillance (E) Working Group for Consideration numbers 7, 8 and 9, but also sent to the NAIC Statutory Accounting Principles (E) Working Group for its existing work related to these Considerations.

9. Broader considerations exist around asset manager affiliates (not just PE owners) and disclaimers of affiliation avoiding current affiliate investment disclosures. A new Schedule Y, Pt 3, has been adopted and is in effect for year-end 2021. This schedule will identify all entities with greater than 10% ownership – regardless of any disclaimer of affiliation - and whether there is a disclaimer of control/disclaimer of affiliation. It will also identify the ultimate controlling party.
    a. Additionally, SAPWG is developing a proposal to revamp Schedule D reporting, with primary concepts to use principles to determine what reflects a qualifying bond and to identify different types of investments more clearly. For example, D1 may include issuer credits and traditional ABS, while a sub-schedule of D1 could be used for additional disclosures for equity-based issues, balloon payment issues, etc. This is a much longer-term project, 2024 or beyond.

Regulator discussion results:

- Regulators recognize the new Schedule Y, Part 3, will give them more insights for owners of greater than 10%, but it does not provide insights for owners of less than 10%. However, regulators also recognize that existing and/or referral work of the Risk-Focused Surveillance (E) Working Group may help with some of this dynamic. Additionally, since the SAPWG 2022 code project and its longer-term Schedule D revamp project will help provide further disclosures that will assist with this consideration, regulators are comfortable waiting to see if further regulatory guidance is needed after using the resulting disclosures and other enhancements from these projects.
    - Specific to owners of less than 10%, regulators discussed the April 19, 2022, Insurance Circular Letter No. 5 (2022) sent by the New York Department of Financial Services to all New York domiciled insurers and other interested parties. This letter highlights that avoiding the levels deemed presumption of control, e.g., greater than 10% ownership, does not create a safe harbor from a control determination and the related regulatory requirements. The circular letter was distributed to all MWG members and interested regulators.

10. 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, and involve a lack of transparency. (The NAIC Capital Markets

Bureau continues to monitor this and issue regular reports, but much of the work is complex and time-intensive with a lot of manual research required. The NAIC Securities Valuation Office will begin receiving private rating rationale reports in 2022; these will offer some transparency into these private securities.)

a. LATF's exposed AG includes disclosure requirements for these risks as well as how the insurer is modeling the risks.
b. SVO staff have proposed to VOSTF a blanks proposal to add market data fields (e.g., market yields) for private securities. If VOSTF approves, a referral will be made to the Blanks WG.

Regulator discussion results:

- Regulators focused on the need to assess whether the risks of these investments are adequately included in insurers' results and whether the insurer has the appropriate governance and controls for these investments. Regulators discussed the potential need for analysis and examination guidance on these qualifications.
- To assist regulators in identifying concerns in these investments, regulators expressed support for the VOSTF proposal to obtain market yields to allow a comparison with the NAIC Designation. Once such data is available, regulators ask NAIC staff to develop a tool or report to automate this type of initial screening. Also, regulators again recognized the SAPWG Schedule D revamp work will help in identifying other items for initial screening.
- The regulators discussed LATF's exposed AG, noting the Actuarial Memorandum disclosures that would be required for these privately structured securities along with the actuarial review work, and recognizing how those would be useful for analysts and examiners when reviewing these investments. Additionally, the Valuation and Analysis (E) Working Group would be able to serve as a resource for some of these insights for states without in house actuaries.
- As a result of the above discussions, regulators agreed to a referral to the Examination Oversight (E) Task Force to address the disclosures that will be available from LATF's exposed AG. They agreed to wait for any further work or referral until they have an opportunity to work with the results of the VOSTF proposal and the SAPWG Schedule D revamp project.
- Since reserves are not intended to capture tail risk, refer this item to the NAIC RBC Investment Risk and Evaluation (E) Working Group and monitor the Working Group's progress. (Regulators adopted this recommendation from the RRC comment letter.)

RRC Comments on "privately structured securities" (2 bullet points, 1 with 2 sub-bullets) – These bullet and sub-bullet points will be included in the referral to the NAIC Examination Oversight (E) Task Force for Consideration #10 but also sent to the NAIC Valuation of Securities (E) Task Force for its existing work related to this Consideration.

AIC Comment on "Privately Structured Securities" (6 bullets) – Regulators asked the AIC to follow the work of the NAIC Examination Oversight (E) Task Force and the NAIC Valuation of Securities (E) Task Force and provide comments on specific recommendations if needed.

11. The level of reliance on rating agency ratings and their appropriateness for regulatory purposes (e.g., accuracy, consistency, comparability, applicability, interchangeability, and transparency).
    a. VOSTF has previously addressed and will continue to address this issue. A small ad hoc group is forming (key representatives from NAIC staff, 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.

Regulator discussion results:

- Regulators agreed to monitor the work of the ad hoc group in lieu of any specific recommendations at this time. Recognizing this will likely be a multi-year project, regulators reserve the right to raise specific concerns that may arise as the various NAIC committee groups work to address this list of considerations.

12. The trend of life insurers in pension risk transfer (PRT) business and supporting such business with the more complex investments outlined above. (Enhanced reporting in 2021 Separate Accounts blank will specifically identify assets backing PRT liabilities.) Considerations have also been raised regarding the RBC treatment of PRT business.
    a. **LATF has exposed an Actuarial Guideline** to achieve a primary goal of ensuring claims-paying ability even if the complex assets (often private equity-related) did not perform as the company expects, and a secondary goal to require stress testing and best practices related to valuation of non-publicly traded assets (note – LATF's considerations are not limited to PRT). Comment period for the 2nd exposure draft ends on May 2.

       Regulator discussion results:

       - Regulators focused on the need to have disclosures on the risks to the General Account from the Separate Account PRT business – for guarantees but also reporting/tracking when the Separate Account is not able to support its own liabilities. Regulators noted the need to address the differences between buy in PRT transactions and buy out.
       - Regulators are comfortable LATF is addressing the reserve considerations. To address the disclosure considerations, regulators support sending a referral to the Statutory Accounting Principles (E) Working Group since regulators suggested it be an item in the Notes to Financial Statements. (Regulators noted it might help to discuss such disclosure concepts with LATF's Valuation Manual 22 (A) Working Group.)
          - While the exposed AG is not limited to PRT, and general disclosures may be helpful, regulators recognized additional and/or more specific disclosures may be needed for PRT business.

    b. Review applicability of Department of Labor protections resulting for pension beneficiaries in a PRT transaction.

       Regulator discussion results:

       - Regulators discussed concerns regarding potential differences between the pension benefit and the group annuity benefit in the PRT transaction.
       - Regulators directed NAIC staff to further research this item for the MWG to address in the near future, including potential discussions with Department of Labor representatives.

    c. Review state guaranty associations' coverage for group annuity certificate holders (pension beneficiaries) in receivership compared to Pension Benefit Guaranty Corporation (PBGC) protection.
       i. NOLHGA provided 2016 study of state guaranty fund system vs. PBGC.

       Regulator discussion results:

       - Regulators recognized the difficulty in comparing the state guaranty system to the Pension Benefit Guarantee Corporation, as detailed in the NOLHGA study. However,

they agreed policyholders should appreciate the benefit of having solvency regulators

actively monitoring and working with the insurance companies in an attempt to prevent the need for any guaranty fund usage, as standard corporations holding pension liabilities have significantly less regulatory oversight.
- Regulators found the NOLHGA study responsive to this consideration, thus they suggested no further action.

d. "Considerations have also been raised regarding the RBC treatment of PRT business."
Regulator discussion results:
- Regulators recognized the work of the Longevity Risk Transfer (LRT) Subgroup of the Life Risk-Based Capital (E) Working Group covers PRT business. A new LRT charge was included in the 2021 Life Risk-Based Capital (LRBC) formula. Regulators agreed the results of this new charge should be monitored.
- While regulators agreed to follow the work of the LRT Subgroup, they suggested no further action at this time.

13. Insurers' use of offshore reinsurers (including captives) and complex affiliated sidecar vehicles to maximize capital efficiency, reduce reserves, increase investment risk, and introduce complexities into the group structure.
    a. LATF's exposed AG was modified to require the company to provide commentary on reinsurance collectability and counterparty risk in the asset adequacy analysis memorandum. The original concept of requiring life insurers to model the business itself even if it uses these mechanisms to share/transfer risk was deferred to allow time to consider and address concerns over potential violations with EU/UK covered agreements and the 2019 revisions to NAIC Models 785 and 786.

Regulator discussion results:
- Regulators held candid conversations about the need to understand why insurers are using these types of offshore reinsurers. If there are problems in the U.S. regulatory system that are driving insurers to utilize offshore reinsurers (e.g., "excess" reserves), we should know of those problems so we can consider if there are appropriate changes to make.
- If there are other drivers, per the common theme in the regulators' review of this list of considerations, there isn't a presumption that the use of these transactions is categorically bad. Rather, there is a need to understand the economic realities of the transactions so the regulators can effectively perform their solvency monitoring responsibilities.
    - Regulators discussed the potential concept of additional Holding Company Act requirements if these are affiliated reinsurers, disclosing the insurer benefits (reserves, capital, etc.).
- Regulators deferred specifying action on this item at this time, instead noting the desire to have meetings with industry representatives using these transactions and regulators from some of the offshore jurisdictions to gain more insights.

Northwestern Mutual Comment (2 cautions) – These cautions will be included as part of the MWG's future discussions and work for this Consideration.
- Caution: Reinsurance transactions can and often do serve a valuable function by reallocating risk. However, offshore reinsurance can also result in lower total reserves and capital, reduced state regulatory oversight, and diminished stakeholder transparency from what would be required by the statutory accounting and risk-based capital requirements the NAIC has established to protect policyholders in the United States.

- Caution: Without progress and action on the item pertaining to offshore reinsurance, the Working Group's progress on other MWG Considerations could further incentivize even more utilization of offshore reinsurance transactions and undercut the NAIC's efforts to close other solvency regulatory gaps domestically. In the long run, a system that encourages companies to transfer business to a related offshore entity in order to alter their reserves and capital from uniform standards diminishes the strength of reserve and capital regulation in the United States. If capital standards are deemed to be too conservative in the US, they should be addressed transparently and uniformly through the NAIC and not through the alternate means of offshore reinsurance.

- **Additional regulator discussion result:**
  - Similar to the result of discussions for the 13th consideration, regulators expressed a desire to meet with various industry representatives to discuss the incentives behind private equity ownership of insurers and conversely the concerns other industry members may have with such ownership. Regulators believe the insights from these conversations will benefit their ability to monitor and, when necessary, contribute to the work occurring in the various NAIC committee groups regarding these considerations.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-08-11 - Summer NM/06 - MWG Referral/2022-011.02 Planfor the List of MWG Considerations - PE Related and Other.docx

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

2023 Proposed Charges

VALUATION OF SECURITIES (E) TASK FORCE

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

Ongoing Support of NAIC Programs, Products or Services

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

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

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

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

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

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

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

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

H. Identify potential improvements to the filing exempt process (the use of credit rating provider ratings to determine an NAIC designation) to ensure greater consistency, uniformity and appropriateness to achieve the NAIC's financial solvency objectives.

I. Implement policies to oversee the NAIC's staff administration of rating agency ratings used in NAIC processes, including staff's discretion over the applicability of their use in its administration of filing exemption.

J. 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.

NAIC Support Staff: Charles Therriault, Marc Perlman

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-08-11 - Summer NM Folder Updates/02 - Proposed Charges/2022-xxx.xx Task Force Proposed 2023 Charges.docx

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: Additional Market Data Fields for Bond Investments

DATE: February 25, 2022

The SVO proposes adding additional market-data fields for bond investments to the annual statement instructions based on 2010 adopted recommendations of the Rating Agency (E) Working Group (RAWG) and the IAO staff's findings regarding the discrepancies between ratings, presented in its Nov. 2021 memo.

The RAWG was formed after the Financial Crisis of 2008 and was charged with gathering and assessing information on:

1. *The problems inherent in reliance on ratings, including impact on the filing exempt ("FE") process and Risk-Based Capital ("RBC");*
2. *The reasons for recent rating shortcomings, including but not limited to structured security and municipal ratings;*
3. *The current and potential future impact of ratings on state insurance financial solvency regulation; and*
4. *The effect of the use of NRSRO ratings on public confidence and public perception of regulatory oversight of the quality of insurance.*

The RAWG made the following summary recommendations in their Apr. 28, 2010, report that was adopted by the Financial Condition (E) Committee (emphasis added):

1. *Regulators **explore how reliance** on ARO (Approved Ratings Organization) ratings **can be reduced** when evaluating new, structured, or alternative asset classes, particularly by **introducing additional or alternative ways to measure risk**;*
2. ***Consider alternatives for regulators' assessment of insurers' investment risk**, including **expanding the role of the NAIC Securities Valuation Office** ("SVO"); and*

3. *When considering continuing the use of ratings in insurance regulation, the* ***steps taken by the NRSROs in correcting the causes that led to recent rating shortfalls****, including the NRSROs' efforts in implementing the recommended structural reforms, should be taken into account.*

As the IAO staff demonstrated with the analysis in its Nov. 29, 2021, memo regarding ratings discrepancies, not all credit rating provider (CRP) ratings reflect a reasonable assessment of a security's risk, indicating that rating shortfalls persist today. The NAIC has not made additional progress in reducing reliance on CRPs and the IAO proposed several steps in its memo to accomplish that objective. As noted by the RAWG and reflected in the IAO's memo, there persists a situation where "*… ratings are neither consistent nor uniform for individual securities, nor across different types and classes of securities…*" However, the role of the SVO has not been expanded to include "*… evaluating credit and other risks of securities*."[1]

One step towards introducing alternative ways to measure a security's risk would be to require insurers to report various analytical measures about each security including metrics such as its current market yield, interest rate sensitivity, spread relative to risk-free securities such as United States Treasuries and average remaining life. The more a security's market yield and spread differ from similarly rated securities, the more likely it is that the implied market-perceived risk of that security differs from the risk indicated by the credit rating assigned to it. The yield difference or spread in basis points can potentially help identify securities whose risk assessment warrants further review by the SVO, examiners or other regulatory groups, for example, a AAA rated security with a yield of 5%. Other fields that measure a security's price sensitivity to interest rate movements may also help to identify market-perceived risk inconsistent with the assigned credit rating. These additional market data fields would align with the RAWG's referral to the Task Force and SVO Initiatives (EX) Working Group, as noted in their following detailed recommendations (emphasis added):

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

Recommendation: The SVO recommends the following market data fields and related descriptions be added to all the annual statement instructions, through a referral to the Blanks (E) Working Group, for all bonds reported on Schedule D, Part 1 (those within scope of SSAP No. 26R – Bonds and SSAP No. 43R – Loan-Backed and Structured Securities). To allow sufficient time for insurers to update their systems, the SVO further recommends that the changes be implemented as electronic only fields effective beginning with the reporting year ending December 31, 2023.

- Market Yield – The Market Yield is the internal rate of return discount rate that makes the net present value (NPV) of all expected cash flows equal to zero in a discounted cash flow analysis. Therefore, Fair

[1] Evaluating the Risks Associated with NAIC Reliance on NRSRO Credit Ratings – Final Report of the RAWG to the Financial Conditions (E) Committee, April 28, 2010

Value, which is already reported, is the present value (PV) of all expected cash flows discounted at the Market Yield.

- Market Price – The Market Price per unit of Par Value, which is already reported, is reflected in the Fair Value as of the financial statement date. The Market Price, which excludes accrued interest, when multiplied by Par Value and divided by 100 will be equal to the Fair Value.
- Purchase Yield – The Purchase Yield is the internal rate of return discount rate that makes the net present value (NPV) of all expected cash flows equal to zero in a discounted cash flow analysis as of the Acquired Date. Therefore, Actual Cost is the present value (PV) of all expected cash flows discounted at the Purchase Yield as of the Acquired Date.
- Weighted Average Life – The Weighted Average Life is the average length of time that each dollar of unpaid principal remains outstanding. The time weightings used in weighted average life calculations are based on payments to the principal. The calculation is "weighted" because it considers when the payments to the principal are made—if, for example, nearly all of the principal payments are made in five years, WAL will be close to five years. Weighted average life does not consider payments to interest on the loan. This value is recalculated at each statement date for the remaining principal payments.
- Spread to Average Life UST - The spread is the difference between the interpolated U.S. Treasury bond yield that matches the reported debt security's Weighted Average Life. Spreads between interpolated U.S. Treasuries and other bond issuances are measured in basis points, with a 1% difference in yield equal to a spread of 100 basis points.
- Option Adjusted Spread - The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return (typically U.S. Treasury yield), which is then adjusted to take into account an embedded option and expressed in basis points. The spread is added to the fixed-income security price to make the risk-free bond price the same as the bond. The option-adjusted spread considers historical data such as the variability of interest rates and prepayment rates. These calculations are complex since they attempt to model future changes in interest rates, prepayment behavior of mortgage borrowers, and the probability of early redemption.
- Effective Duration - This is a duration calculation for bonds that have embedded options. This measure of duration takes into account the fact that expected cash flows will fluctuate as interest rates change and is, therefore, a measure of risk given the security's Fair Value. As a formula, Effective Duration = (P(1) - P(2)) / (2 x P(0) x Y), where P(0) = the bond's Market Price per $100 worth of par value, P(1) = the price of the bond if the yield were to decrease by Y percent, P(2) = the price of the bond if the yield were to increase by Y percent, and Y = the estimated change in yield used to calculate P(1) and P(2).
- Convexity - This is a measure of the curvature, or the degree of the curve, in the relationship between bond prices and bond yields. Convexity demonstrates how the duration of a bond changes as the interest rate changes.
- VISION ISSUE ID: The NAIC VISION system security ID reported in AVS+.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-06-09 - Interim Meeting/02 - Blanks Referral Analytical Risk Measures/2021-053.01 Blanks Market Data Disclosure v2.docx

Mike Monahan
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May 20, 2022

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

Re: A Proposed Referral to the Blanks (E) Working Group to Add Fixed Income Analytical Measures to Investments Reported on Schedule D, Part One – Additional Market Data Fields for Bond Investments – Comments Due May 20, 2022

Dear Ms. Mears,

The undersigned (ACLI, APCIA, PPIA, NASVA) appreciate the opportunity to comment on the exposure entitled "Additional Market Data Fields for Bond Investments" that was released for comment by the NAIC Valuation of Securities Task Force (VOSTF).

The undersigned note that the memorandum from the Securities Valuation Office (SVO) does not fully discuss or specify how the SVO, VOSTF and/or other regulators who would receive the analytic

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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APCIA is the primary national trade association for home, auto, and business insurers. APCIA promotes and protects the viability of private competition for the benefit of consumers and insurers, with a legacy dating back 150 years. APCIA members represent all sizes, structures, and regions—protecting families, communities, and businesses in the U.S. and across the globe.

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.

data included in the proposal would utilize that information and why it is of value to them. This is especially important given the costs associated with compliance by the industry.

The undersigned understand that one of the reasons for requesting this analytic data is to compare market yields for securities with rating agency (CRP) ratings, in order to identify outlier ratings (of 2x plus variances) where the market (through demanding higher yields) ascribes more risk to a particular security than the CRP rating would imply (e.g., the excess spread above the "risk free", or US Treasury rate, exceeds the expectation for the security's inherent credit risk, and if applicable, for illiquidity and/or complexity premium).

The undersigned also understand this is especially desired for privately offered structured securities – e.g., as noted under item 10 of the Summary of Referrals from Macroprudential Working Group "Regulatory Considerations Related to but not exclusive to PE" exposure, with comments due June 13, 2022, as well as from comments from various NAIC staff and regulators.

Given the costs associated with this request, the undersigned would appreciate further dialogue on how the data will be utilized and the tangible benefits to regulators. This discussion would allow the benefits to be weighed against the substantial costs associated with providing the data, i.e., compliance with the proposal.

For public securities much, if not all, of this data is already available from other commercially available sources (e.g., Bloomberg, Clearwater, Aladdin, etc.) and it may be more feasible for the SVO to aggregate this data, rather than have each individual insurance company incur the costs to implement systems changes and provide the data. This is especially true when considering that much of the requested data is based on somewhat complex modeling and outputs are heavily dependent upon inputs, which by their nature require significant judgment and therefore will vary by company.

For private securities, the SVO has (or will have) meaningful data from Private Rating Rationale Reports which are likely meant to help address rating agency disparity concerns.

Our comments below are organized into two different sections – 1) Utility of the Data for Regulators and 2) Compliance Costs for Industry. The undersigned's desire is to help address valid regulator concerns in the most cost beneficial way.

Utility of the Data for Regulators

This section of our letter will address each requested piece of data individually.

<u>Market Yield</u> – The Market Yield is the internal rate of return discount rate that makes the net present value (NPV) of all expected cash flows equal to zero in a discounted cash flow analysis. Therefore, Fair Value, which is already reported, is the present value (PV) of all expected cash flows at the Market Yield.

We would not expect this data to be very useful or insightful for the vast majority of securities that will be reported as Issuer Credit Obligations under the new Statutory Accounting Principles Working Group (SAPWG) Proposed Bond Definition (e.g., US Treasuries, US Government Agency, Municipal Bonds, Public Corporate Bonds or Private Corporate Bonds that are designated by the SVO and issued from operating entities). Further, for publicly rated securities, the NAIC has access to analytic data through public information sources, such as Bloomberg.

In addition, the vast majority (~75%) of what will be reported as asset-backed securities (ABS) under the new SAPWG Proposed Bond Definition (e.g., CMBS, RMBS, and potentially CLOs) are, or potentially will be, modeled by the SVO and provided an SVO designation with no weight given to CRP ratings.

For much of the remaining securities, both private credit issuer obligations and private ABS, with a private letter rating, pricing is frequently done via "matrix pricing". While there is a variety of different methodologies utilized, this pricing methodology often uses some type of yield attributed to internal designations (e.g., use of a CRP rating, and related public index-derived yield, or an internal rating, with a similar index-derived yield). Some companies, in whole or in part, also utilize broker provided spreads or quotes for determining market values. At a minimum, there will be meaningful inconsistencies in the data supplied, as each insurer may bring different methodologies to bear in the market valuation process.

Worse, the data could be of dubious usefulness. For example, if a company internally rates a security as a BBB (based on an external CRP's BBB rating) and uses a BBB index bond yield to determine fair value, the market yield reflected will closely approximate average BBB yields for public bonds and will not signal whether a security is more or less risky than a typical BBB bond. Said differently, because CRP ratings are a critical variable in determining matrix-based market pricing, it would be a circular process to then use a matrix pricing-derived market yield to identify CRP rating outliers.

The undersigned therefore question the utility of this data to the SVO and regulators.

<u>Market Price</u> – The Market Price per unit of Par Value, which is already reported, is reflected in the Fair Value as of the financial statement date. The Market Price, which excludes accrued interest, multiplied by Par Value and divided by 100 will be equal to the Fair Value.

This information is already currently reported in column 8 of Schedule D. The electronic only columns further identify the source of the market price and the fair value level attributed to it. It is unclear if the SVO is looking for something more on this item.

<u>Purchase Yield</u> – The Purchase Yield is the internal rate of return discount rate that makes the net present value (NPV) of all expected cash flows equal to zero in a discounted cash flow analysis as of the Acquired Date. Therefore, Actual Cost is the present value of all expected cash flows discounted at the Purchase Yield as of the Acquired Date.

The undersigned note that the Effective Rate of Interest is already included on Schedule D (Column 17) and defined in the reporting instructions as follows:

> *For issuer obligations, include the effective rate at which the purchase was made. For mortgage-backed/loan-backed and structured securities, report the effective yield used to value the security at the reporting date. The Effective Yield calculation should be modified for other-than-temporary impairments recognized.*

The undersigned note that both of these definitions essentially equate book value to the future expected cash flows, which is the same as NPV = 0. Therefore, it makes sense to align these definitions to ensure the information being utilized by regulators is being efficiently obtained. Further, book yield is an objective yield that may be more beneficial for the stated intent (i.e., yield disparity for an initial CRP rating).

The utility of purchase yield for purposes of identifying excess spread, is the most relevant as it compares the excess spread, to a CRP rating when the deal is committed to. Purchase yield is a fact. For private securities, all valuations assigned subsequent to time of commitment are educated estimates. These estimates may vary for any number of reasons, beyond just the CRP rating including: short-term market movements, impairments, changing circumstances with respect to specific companies or industries, delay in rating agency downgrades, etc. For outliers, the SVO can certainly dig deeper to identify the root causes – e.g., for private securities, note purchase agreements, rating rationale reports, copies of the notes, etc. which the SVO should already have; for public securities, Bloomberg or SEC websites are readily available. In short, in attempting to identify 2x plus variances, the spread over the US Treasury rate (utilizing purchase yield at the time of commitment is going to be the most significant indicator of an outlier CRP rating. The remaining data has very limited additional value in identifying such outliers – e.g., duration matters but is less impactful as it pertains to identifying 2x variances.

Weighted Average Life (WAL) – The Weighted Average Life is the average length of time that each dollar of unpaid principal remains outstanding. The time weightings used in weighted average life calculations are based on payments to the principal. The calculation is "weighted" because it considers when the payments to the principal are made—if, for example, nearly all the principal payments are made in five years, WAL will be close to five years. Weighted average life does not consider payments to interest on the loan. This value is recalculated at each statement date for the remaining principal payments.

WAL can be thought about as a way of estimating the tenor of an investment and is often considered in establishing the interest rate. On a stand-alone basis, the undersigned do not understand why the WAL is particularly useful as other factors related to each investment are considered. The value of WAL as a measure may be diminished when there is potential variability in cash flows due to embedded options or in asset-backed securities. This potential for cash flow variability also increases the likelihood that the WAL measure will vary by company. Therefore, focusing on spread over the US Treasury rate (utilizing purchase yield) should be sufficient to identify outliers. See our discussion on duration below.

Spread to Average Life UST (UST Spread) - The spread is the difference between the interpolated
U.S. Treasury bond yield that matches the reported debt security's Weighted Average Life. Spreads between interpolated U.S. Treasuries and other bond issuances are measured in basis points, with a 1% difference in yield equal to a spread of 100 basis points.

Option Adjusted Spread (OAS) - The option-adjusted spread is the measurement of the spread of a fixed income security rate and the risk-free rate of return (typically U.S. Treasury yield), which is then adjusted to take into account an embedded option and expressed in basis points. The spread is added to the fixed income security price to make the risk-free bond price the same as the bond. The option-adjusted spread considers historical data such as the variability of interest rates and prepayment rates. These calculations are complex since they attempt to model future changes in interest rates, prepayment behavior of mortgage borrowers, and the probability of early redemption.

Both the UST Spread and OAS are certainly different ways to calculate the spread over the US Treasury rate, just as with using purchase yield and market yield.

For securities without embedded prepayment or extension risk, we believe spread at time of commitment (e.g., utilizing the purchase yield) will be the most relevant metric and will be most meaningful to the SVO and regulators.

For securities with embedded prepayment or extension risk, while OAS could provide some incremental additional insight, it also has some additional drawbacks. Calculating the OAS involves projecting many future interest-rate scenarios and their probabilities, as well as assumed borrower behavior. To the extent that each insurer has its own proprietary optionality model, OAS for the same security will differ insurer to insurer.

In any case, these are just other forms of spread over treasury which the undersigned believe are unnecessary when trying to identify 2x plus variances, especially considering the costs for each company to comply, and their reliability due to subjective inputs in a complex calculation. Therefore, focusing on spread over the US Treasury rate at time of commitment (utilizing purchase yield) should be sufficient to identify outliers.

Lastly, there is concern among industry that this data would be inconsistent with other data utilized by insurance companies (e.g., the NAIC Valuation Manual for Life and Annuity Reserves requires the use of spreads in very prescriptive form).

Effective Duration - This is a duration calculation for bonds that have embedded options. This measure of duration takes into account the fact that expected cash flows will fluctuate as interest rates change and is, therefore, a measure of risk given the security's Fair Value. As a formula, Effective Duration = (P(1) - P(2)) / (2 x P(0) x Y), where P(0) = the bond's Market Price per $100 worth of par value, P(1) = the price of the bond if the yield were to decrease by Y percent, P(2) = the price of the bond if the yield were to increase by Y percent, and Y = the estimated change in yield used to calculate P(1) and P(2).

Convexity - This is a measure of the curvature, or the degree of the curve, in the relationship between bond prices and bond yields. Convexity demonstrates how the duration of a bond changes as the interest rate changes.

Both Effective Duration and Convexity are interest rate risk measures and are not indicators of credit risk. While such measures are certainly useful for a life insurance company, it is primarily in the context of comparing the duration and convexity of their asset portfolios to the duration and convexity of their liabilities. These data are most useful in estimating prices given changes in interest rates, while the price drivers are based on an investor's view of cash flows, including any embedded options. Because of this, we question their ability to explain a 2x variance in the purchase yield. Additionally, these calculations require very challenging assumptions on volatility which would certainly lead to different outcomes for different companies. Thus, in the context of the varying assumptions on the inputs, and the limited value in identifying 2x variances, the undersigned do not believe there is sufficient value in pursuing the creation of these fields.

VISION ISSUE ID - The NAIC VISION system security ID reported in AVS+.

The undersigned are not aware of any instance in which the VISION ISSUE ID is currently captured by industry, nor included on any reporting schedule. If a company is a filer of a particular security, they typically do not save the VISION ISSUE ID, and if they are not the filer, they would have no reason to seek and retain it.

Due to these factors and our limited understanding of the technical architecture of the NAIC VISION system, the undersigned wonder whether the SVO could utilize the identifiers (e.g., CUSIP) for each investment on Schedule D to cross-reference the VISION ISSUE ID.

Compliance Costs for Industry

The effort and cost of supplying this data is significant. We see the effort broken into two challenges: data capture and creation of the electronic Schedule D:

The data capture challenge fits into one of the following scenarios:

- The data in whole or in part is not utilized by some companies for a variety of reasons, including because some companies do not manage their investment portfolio internally,
- The data is utilized by companies on an ad hoc basis and is not saved or stored, or
- If the data is saved or stored, it is done so on a de-centralized basis and not maintained in the companies' reporting systems.

Capturing the data is only one of the challenges. In order to deliver the requested data fields, the data would need to be included in the electronic Schedule D that is included in a Company's Annual Statement software package. There are several vendors that provide annual statement packages, and they work similarly. Each schedule is loaded to the package as a flat file in the specified format. Flat files are a collection of records in which the data follows a uniform format and follows rules on value types where applicable. The database is flat because every line only holds one data input, depending on the categorization of the columns within the file. The software packages can't take feeds from multiple sources to prepare the schedule. The annual statement software providers likely won't change their requirements to facilitate creation of the schedule that includes these fields so it would be up to companies to create the reporting in the required flat file.

Today, the Schedule D flat files are generated by the investment accounting system used by the company. There are several of these systems in the market. Most, if not all, of these systems do not contain information or programming to calculate the requested fields. Nor do they have a place to store the data with programming to reference such stored fields to facilitate the requested reporting. To do this would be a significant, and likely expensive, development project.

Because of these circumstances, the creation of the requested electronic Schedule D would require a manual process that combines information from multiple data sources. Beyond the cost of creating this manual process and previously stated concerns about data availability, implementing this process in a controlled manner that is required for all financial reporting would require development and testing, which would take considerable time, in addition to the implementation and ongoing cost, given the complexity. Coupled with the other significant NAIC activities, the resources to implement this broad and extensive proposal are very challenging even with a proposed year-end 2023 effective date.

These data capture and schedule creation scenarios present varying degrees of significant challenges in providing the requested information on potentially thousands or tens of thousands of securities for a single company. Each would require companies to develop and maintain processes and internal controls over centralized data capture and financial reporting protocols for data elements which currently don't exist.

Conclusion

Given the concerns expressed above; the data may be available from other sources, the potential lack of utility of the requested data, and the costs and efforts to comply, the undersigned would like to work with regulators to get a better understanding of the actual need for this data, as well as how

the SVO expects to use the data. This would allow us to provide more constructive feedback on this proposal so it can be implemented in the most cost-efficient manner. Due to the significant effort and cost associated with complying with this proposal, for each and every insurance company, it should be evaluated against the actual benefits that will accrue to regulators, especially in the context of other SVO/VOSTF initiatives. The undersigned believe it would be unwise to hastily implement this proposal "as is" only to acknowledge later that the utility of this data is of limited value. Furthermore, we would like to explore whether it is more cost efficient for such data, or a subset of such data, to be centrally aggregated by the SVO for their use in analysis, rather than by insurers individually.

Thank you for considering the undersigned comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey

Tracey Lindsey NASVA

John Petchler

John Petchler
on behalf of PPiA Board of
Directors

Stephen W. Broadie
Vice President, Financial & Counsel

Cc: NAIC Staff Interested
Parties

May 19, 2022

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

RE: A Proposed Referral to the Blanks (E) Working Group to Add Fixed Income Analytical Measures to Investments Reported on Schedule D, Part One – Additional Market Data Fields for Bond Investments – Comments Due May 20, 2022

Dear Ms. Mears

This letter is in response to the recent SVO recommendation for a number of additional market data fields to by supplied by insurers for all bond Investments. We understand that the additional data, all of which relates to the pricing of securities, would be used by the SVO to "screen" securities and identify outliers "whose [NRSRO] risk assessment warrants further review by the SVO" with the ultimate goal of assessing the reliability of NRSRO ratings. While the memo does not lay out in detail how this screening process would be implemented, we would like to point out several factors for regulators to consider:

To begin with, we are sure that regulators understand that credit is not the sole determinant of price (or yield) for any security. Many factors which are not credit-related influence the pricing of security. In addition to deal-specific factors such as callability or extension risk, which may or may not be factored into a credit rating, these can include regulatory risk, market timing, frequency -- or scarcity -- of offerings for a particular type of investment, investor appetite -- or capacity limits -- for specific credits, etc. etc. Any screening process to identify securities for further credit review based primarily on pricing averages must also take these factors into account.

While in the public bond markets it is broadly true that credit and price -- risk and reward -- are correlated, this relationship is much weaker in the private markets. For public bonds, it is the "market" which determines at what price (or yield) any given investment will 'clear' the market. For this reason, in the public market individual investors -- including insurance companies -- are all "price-takers": the only decision being whether or not to participate in an investment at the given market yield.

In the private market individual investors are frequently able to exert a considerable influence on pricing. This is particularly true on smaller "bespoke" deals tailored to meet the investment needs of a small group of investors, and where transaction terms, including pricing, are much more highly-negotiated than is possible with public offerings. For this reason, the variability of pricing is much larger in the private market than it is for public debt.

In fact, the private markets, and particularly these smaller niche investments, are one of the few places insurance companies are occasionally able to find "value" in the market: that is, being well-compensated relative to the estimated risk of a given transaction (many of us would say "adequately compensated" relative to public markets). This is one of the main reasons insurance companies participate in private debt transactions to begin with. It would be a shame if any screening process resulted in insurance companies being penalized for their ability to occasionally find "value" in the private markets.

Secondly, even looking at broad market averages, there is no fixed correlation between public and private bond spreads over time. The relationship between the two markets fluctuates widely and is influenced by many factors. Since the only available data set is a historical one for public bond ratings and spreads, any extrapolation of these into the private bond market at different points in time is bound to be a very imperfect exercise.

Even if there were a fixed relationship between the two markets, as mentioned above, the variability in pricing *within* the private market at any given credit rating is much greater than for public bonds -- a measure of the relative "inefficiencies" that can still occasionally be found in the private markets. The use of average historical public bond spreads as a screen for an appropriate private bond credit rating could lead to many "false positives", and needs to be supplemented by rigorous analysis of the specific transaction and a detailed critique of the NRSRO's own rating analysis.

For these reasons we believe that any use of market yields -- particularly broad historical indexes of public market average yields or spreads applied to private bonds -- must take all these factors into account.

Finally, as long as Filing Exemption remains in place, any designation by the SVO which would override the rating of a nationally-recognized ratings provider should be the result of a transparent methodology and ratings report by the SVO supplied to the investor -- similar to those supplied by the nationally-recognized providers -- and also subject to appeal by the holder of security.

We appreciate the opportunity to offer these comments and are happy to discuss this letter and any questions you might have with the members of the Task Force.

Sincerely,

John Garrison

On behalf of: The Lease-Backed Securities Working Group.

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May 20, 2022

Ms. Carrie Mears, Chair
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Re: Proposed Referral to the Blanks (E) Working Group to Add Fixed Income Analytical Measures to Investments Reported on Schedule D, Part One – Additional Market Data Fields for Bond Investments

Dear Ms. Mears and Task Force Members,

As an independent consultant and long-time observer of the work of the Valuation of Securities Task Force I appreciate the opportunity to comment on the captioned proposal in writing, as I did orally at the most recent NAIC Spring National Meeting.

The proposal is to require insurers to provide additional data concerning their holdings of bonds. Before this proposal is advanced it is important to specify what needs this data can fulfill in order to determine what characteristics may be needed. It is also essential to develop and test the methods, techniques and tools that will use these characteristics to answer the questions that regulators will have. When it is established which characteristics can be used effectively, then it will be appropriate to require their submission.

Objectives

It seems there are two distinct questions insurance regulators might have concerning the investments of insurers in bonds. These are:

- **Question One: To what extent should the credit opinions of the Nationally Recognized Statistical Rating Organizations be relied upon?** and,
- **Question Two: How can insurance regulators, in all of their capacities, better understand the investment risks being assumed by the insurers they regulate?**

A key point here is that these two questions, while seeming quite similar, are actually very different indeed and will require different approaches.

Credit Risk[1] is at the heart of **question one** because credit risk is the single risk element measured by NRSRO ratings. Achieving the desired level of accuracy for these risk opinions is important because they are the source of the vast majority of NAIC Designations that are translated into RBC credit risk factors C1 and R1.

Investment Risk needs to be understood to answer **question two** because it is a broader measure of risk which includes not only credit risk but the broadest range of risks to which an insurer is exposed.

The Differences Between Credit Risk and Investment Risk

Credit risk is simply one specific type of the broader category of investment risks. Credit risk is the sole risk reflected in the C1 and R1 factors for RBC and, in fact, these factors were explicitly designed to measure this one risk element in the RBC calculation. C1 and R1 factors were developed using the credit risk metrics and experience of the NRSROs and recently when they were updated the same credit standards were used. Attempting to add non-credit elements to NAIC Designations may be tempting but that would compromise the integrity of the RBC calculation as NAIC Designations are translated directly into C1 and R1 credit risk factors based on NRSRO data.

Investment risk is the broadest measure of risk of investing in bonds and it includes credit risk. Regulators have been familiar with this distinction for many years and in fact completed a study of risks[2] and found that these, in addition to credit, are risks inherent in bonds: Event, Liquidity, Call/Extension, Deferral, Currency and Leverage, and there are many others that affect yields and, hence, spreads.

Question One: Is Reliance on NRSROs Well-Founded?

The NAIC relies heavily on the nine NRSROs for their bond credit ratings which insurers can use to determine the C1 and R1 factors for Risk Based Capital calculations. This is reasonable because together these NRSROs have thousands of analysts, well-developed public methodologies, robust infrastructures and many other strengths. The essential question insurance regulators need to ask, however, is whether the credit ratings they produce are of sufficient accuracy to be used for C1 and R1 RBC factors so as to assure that the overall RBC calculations are of reasonable accuracy.

Unfortunately measures of spread, however calculated, will measure investment risk and not credit risk so spread metrics cannot be used simply, if at all, to determine the reliability of NRSRO ratings. This may be inconvenient, but it is a reality. This is not to say that this cannot be done, but without the development of complicated and sophisticated tools to distinguish credit risk from the wide range of other factors that affect spreads this would be quite difficult indeed. It should be noted that this has also eluded many in the past.

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[1] Credit risk is commonly defined as the possibility of a loss to a lender resulting from a borrower's failure to repay a loan or meet contractual obligations.

[2] Report of the Risk Subgroup of the IAWG (then an entity of the VOSTF), Attachment Two-A9, VOSTF, 12/06/08. Available upon request.

Other techniques can be used -- but they, too, are not simple. One source of data that is intended to indicate the durability of the ratings over time of NRSROs is, of course, Exhibit 1, "Performance Measurement Statistics" of Form NRSRO which the Securities and Exchange Commission requires and examines annually for all NRSROs. Another resource is the SEC's Annual Report on NRSROs[3] but among its limitations is that it is not specific as to the identities of the individual NRSROs. The methodologies that SEC requires the NSRSOs it regulates to publish could be evaluated for their comprehensiveness. This has greater potential than it might otherwise seem because the SEC itself monitors compliance of each NRSRO with its methodologies even as is does not disclose its findings on an individual basis.
In summary, assessing reliability of NRSRO rating opinions is not an easy task

Question Two

On a macro level various spread metrics can indicate overall level of investment risk but it is very challenging to disaggregate these risks on any scale even though many have attempted to do this.
In addition to the six other-than-credit risks listed above I am sure other commentors will describe many more investment risk elements that result in higher spreads. Complexity is one example. It is difficult to analyze complex securities and insurers that do this difficult work expect to receive compensation in the form of higher yields. Another is innovation. As with complexity, it takes significant resources to evaluate new structures in order to fully understand their risks. Investors expect to be rewarded for their work on this as well and issuers are willing to oblige with higher yields. These are just two examples and it should also be remembered that due to differing liability structures the same characteristic that might increase risk to one insurer might actually dampen risk to another.

An obvious point is how difficult it can be, given a specific bond, to determine if a given insurer has adequately assessed and evaluated the totality of the risks it undertakes. While spread metrics can indicate the presence of risk in aggregate it would take considerable effort to attribute spread differentials to their various underlying sources in order to make them visible. In other words, it is possible to see that risk exists, and an analysis of spreads may facilitate that, but it is exceedingly difficult to determine the exact sources of the risk in order to ascertain whether a given insurer is managing that risk prudently.

It is Possible to Begin Developing Screening Tools Now

Even though the prospects may seem limited, the NAIC could begin working now on developing screening tools. This could be done using existing data available for public securities. The use of publics should not compromise the results given that the SEC mandates that all NRSROs apply exactly the same rating standards to publics and privates and the SEC monitors compliance. Consequently, the lessons learned from beginning work now could potentially point

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[3] SEC Office of Credit Ratings "Annual Report on NRSROs as Required by Section 6 of the Credit Rating Agency Reform Act of 2006"

the direction to developing useful screening tools to answer both questions or, at worst, demonstrate the difficulty of producing effective tools.

Meeting the Needs of Regulators

Even the most carefully thought-out solutions can benefit from input from the parties they are intended to benefit. It is quite possible that that a broad range of regulators could find productive uses for additional data. It would be beneficial, then, to seek out potential users and involve them in all stages of the development process from goal-setting through prototype development and even follow ups once they have been using the tools that are developed. It should be noted that sometimes users have can make their most useful contributions once they have seen something tangible such as a prototype or well-developed design.

Summary

The two very relevant and important questions of the appropriate extent of reliance on the credit ratings of bonds by NRSROs and how insurance regulators can improve their abilities to identify and assess investment risk are related but separate. One involves pure credit risk whereas the other represents the totality of investment risk. Accordingly, it is likely that more sophisticated tools, rather than simply reviewing various spreads, will be required to achieve improved capabilities.

Conclusion

It seems wise, at the very least, to have tested screening mechanisms in place or at least in the final stages of development prior to requiring insurers to produce more data. It would be very unfortunate to implement data requirements, wait months or years for compliance and then discover that the data or system are insufficient to meet objectives. Even as exploratory work could begin now with existing data, enthusiasm for this needs to be tempered by the realities of how difficult it would be to untangle the web of risks in fixed-income investments either to assess the efficacy and reliability of NRSRO ratings or to better understand the individual risks being undertaken by insurance companies.

Hopefully there are reasonable and practical approaches to improve the answers to the two important questions being discussed but it is not at all likely they will be simple. As H.L Menken once said, "For every complex problem there is an answer that is clear, simple, and wrong". Even so, work could begin to assess the prospects for success and that could indicate what, if any, additional data will be required of insurers. At the very least it is almost certain that valuable lessons would be learned.

Sincerely,

Copies: Charles Therrault
Denise Genao-Rosado

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-08-11 - Summer National Meeting/07 - Blanks Referral Analytical Risk Measures/Anderson Insights to VOSTF 20 May22.docx

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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

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

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

RE: Possible Options for Additional Market Data Fields for Bond Investments

DATE: July 14, 2022

Summary - The SVO proposed adding additional market-data fields for bond investments to the annual statement instructions in its memo dated Feb. 25, 2022, titled "Additional Market Data Fields for Bond Investments" that was discussed at the 2022 Spring National Meeting. The recommendation was based, in part, on 2010 adopted recommendations of the Rating Agency (E) Working Group (RAWG) and the NAIC Investment Analysis Office's (IAO) staff's findings regarding the discrepancies between ratings, presented in its Nov. 29, 2021 memo, "Rating Issues and Proposed Changes to the Filing Exemption Process." In this memo the SVO further outlines the regulatory benefits and proposes two possible approaches.

The benefits of collecting additional market-data for each insurer bond investment are several:

- Assist in SVO identification of securities with credit rating provider (CRP) ratings which may be inconsistent with a security's actual overall risk.
- Greater transparency for regulators into the risks and characteristics of insurer investments.
- Incorporation of insurer investment portfolio analysis into the examination process.
- Availability of more Level 1 and 2 Inputs which will be included in the AVS+ pricing data for all securities compared to the mostly Level 3 Inputs for only some securities today.
- Allow state insurance regulators to assess the capabilities of an insurer's investment management or risk management processes by reviewing the quality and accuracy the market data fields.
- Provide NAIC staff with the capability to run cash flow simulations on insurer investments.

Regarding the first bullet, the SVO would use this market-data information to help identify securities with credit rating provider (CRP) ratings that may be inconsistent with the security's actual overall risk. The SVO and SSG have raised concerns over the years about a number of asset classes (e.g. residential

mortgage backed securities (RMBS), commercial mortgage backed securities (CMBS), public and private fund investments, principal protected securities (PPS) including CLO Combo Notes, regulatory transactions, residual interests, and now collateralized loan obligations (CLO), and structure equity and funds) and specific securities in other asset classes where a rating agency rating often does not adequately reflect the investment risk for NAIC purposes. The SVO needs this analytical information so that it can identify and take potential action on investment risk assessment inaccuracies. Without this data and potentially other information in the future, coupled with some level of discretion over NAIC Designations derived from ratings, the SVO and regulators will remain in the dark about these risks. Additionally, the incentive for significant risk-based capital arbitrage utilizing CRP ratings will likely continue to increase and rating agencies will effectively remain a de-facto "super regulator" in that any investment they assign a rating to is automatically 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 statutory framework.

Inconsistent and potentially inaccurate assessments of investment risk is a critical issue not only for the Valuation of Securities (E) Task Force but for other state insurance regulatory groups that are interested in identifying and analyzing investment risks, whether it be at the individual security, asset class, legal entity or industry level. The following are just a few groups that have active work streams involving investment risk: Life Actuarial (A) Task Force, Capital Adequacy (E) Task Force and its Working Groups, Statutory Accounting Principles (E) Working Group, Financial Stability (E) Task Force, Macroprudential (E) Working Group and Financial Analysis (E) Working Group. The proposed market data fields will benefit each of these groups in their work assessing insurer investments and portfolio risks.

The requested market data fields other than purchase yield, which should be available from any investment accounting system, are all at the security issue level (i.e. CUSIP). Any insurer system that can receive security issue level data such as a market prices, credit ratings, bond factors, cashflows, or NAIC Designations should be able to accommodate these proposed security issue-level data fields. The SVO acknowledges this change will require time for insurer system providers to accommodate these new data fields into their data structures and Schedule D reporting applications. However, these data fields are very common in the management of a bond portfolio, and it would be a significant enterprise risk deficiency if an insurer's investment managers did not have them.

Some alternate measures of risk (e.g. Sharpe Ratio and Sortino Ratio) were mentioned during the Task Force discussion. These metrics, however, would require insurers to calculate the total return and the standard deviation of those returns for each security they own in order to produce and report these metrics which would be significantly more costly and more appropriate for assessing relative value and less applicable for assessing investment risk.

Alternatives – The SVO was asked to consider industry's recommendation that the NAIC produce these fields. Below are our thoughts on each alternative.

- **NAIC Produced Analytics** – The SVO can take on the responsibility for producing the analytical data elements requested in this proposal. To do so it would require enhancements to the SVO's existing systems (VISION, AVS+ and STS), and vendor pricing data, investments in new systems to provide the modeling, more staff for the incremental and on-going support of these systems and processes, new data feeds to support the modeling software, and new data bases and reporting capabilities to provide the information to regulators. Enhancements would also

need to include the ability for insurers to provide electronically to the SVO the full security structure of any security that the modeling software does not know about. We strongly believe that the benefits to be gained by state 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 operational.

- **Pros:**
  - Market analytical information would be independently and consistently produced.
  - The SVO's pricing data would need to include more Level 1 and 2 Inputs for all securities versus primarily Level 3 Inputs for only some securities today.
  - Regulators would eventually be able to ask NAIC staff to model the risks or cash flows of any bond security or insurer bond portfolio, including, stress testing those securities and portfolios.
  - Regulators would have significantly greater transparency into the risks and characteristics of insurer investments.
  - Analytical analysis of insurer investment portfolios could be incorporated into the examination process.
  - The overall cost to insurers through any increased fee would likely be much less than each insurer building out its own capability to provide the data.
- **Cons:**
  - The NAIC would need to make significant enhancements to VISION, AVS+, and STS, and develop new reporting data bases.
  - The NAIC will need to license a security analytic modelling system and provide it with the data it requires, some of which may require new data licenses. This includes full access to vendor applications like Bloomberg or Aladdin.
  - The NAIC will incur additional fees for higher level of security pricing data. The NAIC will also need additional staff to develop and support the technology enhancements and to support the on-going modeling of securities and portfolios.
  - It may take longer for the NAIC to build this capability.
  - Insurers would still need to report some of this information on their Schedule D filings from data published through AVS+.
  - Insurers would need to provide the SVO with full security structure modeling and supporting data (e.g. collateral, payments, actions) for any security the analytic modelling system does not have within its data base.

- **Insurer Produced Analytics** – Insurer investment managers should already have the market data fields requested in this proposal. Insurers would need to get this information into their systems that produce their Schedule D filings. This option would require more up-front work on the part of the insurers and less by the NAIC. The uses of the data, however, whether by regulators, the SVO or other interested

NAIC groups, could be significantly more limited than in the first option, because of the inconsistency in data between insurers.

- **Pros:**
  - Insurers already have this information as part of their investment management or risk management processes.
  - State insurance regulators could assess the capabilities of an insurer's investment management or risk management processes by reviewing the quality and accuracy the market data fields.
  - The timeframe to implement would likely be shorter than the SVO having to build out this capability.
- **Cons:**
  - Insurer security pricing is very inconsistent today which will lead to a high degree of variability in these analytical values.
  - The modeling software and assumptions used by insurers to produce these analytical value can vary significantly which will also lead to a high degree of variability in the values.
  - Insurers and their system providers will need to develop new interfaces to ingest this data and produce it in their Schedule D filing. That time frame could vary significantly by vendor and insurer.
  - State insurance regulators would not be able to request the modeling of any investment security or portfolio.
  - Insurers would directly bear the expense of these changes which will likely be greater than it would be it the NAIC produced this information.

Next Steps – The SVO continues to strongly believe that these market data fields are an important first step in finding alternative ways to measure insurers investment risk and reducing the NAIC reliance rating agency ratings. As noted by the RAWG and reflected in the IAO's memo, there persists a situation where "*… ratings are neither consistent nor uniform for individual securities, nor across different types and classes of securities…*" yet the role of the SVO has not been expanded to include using these alternatives in "*… evaluating credit and other risks of securities*." The objective of this request is to begin addressing these investment risk issues but this may not be the only information needed.

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: the NAIC's SVO or insurer reporting? The SVO believes that the first option would provide the most standardization in data and utility to regulators, the SVO and other interested NAIC groups and would be worth the slightly longer time and cost needed to develop the capabilities.

If, as the SVO recommends, the Task Force prefers the NAIC's SVO as the source of this analysis, then the next step would be a referral to the Financial Condition (E) Committee to request their sponsorship for this initiative and, if provided, begin a fiscal request. If Financial Condition (E) Committee declines to sponsor the initiative or if insurer reporting is the preferred source, we would recommend reverting to insurer reporting and directing the SVO staff to prepare the Blanks referral.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-08-11 - Summer National Meeting/07 - Blanks Referral Analytical Risk Measures/2021-053.XX Blanks Market Data Options.docx

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

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

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

RE: Update the Definition of Other Non-Payment Risk Assigned a Subscript "S" in the P&P Manual

DATE: November 15, 2021

Summary – Securities that possess "Other Non-Payment Risks" are intended to be reviewed by the SVO but these investments have not been explicitly included on the list of Specific Populations of Securities Not Eligible For Filing Exemption in Part Three of the *Purposes Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). Securities with other non-payment risks are identified through assignment of the Administrative Symbol "S" as a subscript to the NAIC Designation. This amendment adds "Securities with Other Non-Payment Risks" to the list of securities that are ineligible for filing exemption.

As noted in Part One, paragraph 90, of the P&P Manual, "*An objective of the VOS/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is required to identify securities that contain such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer, so this can be reflected in the NAIC Designation assigned to the security through the application of the notching process.*"

The proposed amendment further clarifies through additional illustrations that securities that:

a) incorporate the performance of other assets to determine their contractual payments, either directly or indirectly through reference pools, equity baskets, or indices;

b) receive payments as the remainder or residual cashflow after all other payment obligations have been made;

c) receive additional performance or bonus cashflows; or

d) have no contractual events of payment default;

would also be considered as having "Other Non-Payment Risks".

Proposed Amendment - The text changes to update the definition of "Other Non-Payment Risks" and include Securities with Other Non-Payment Risk as a security type ineligible for filing exemption is shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2021 P&P Manual format.

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

NAIC DESIGNATION SUBSCRIPT S

Description of Other Non-Payment Risk

32. 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.

33. 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.

34. 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).

35. 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;

- *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 date~~s~~ (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.

- The governing agreements permit irregular or conditional payments that are incompatible with the notion of an issuer making scheduled payments of interest and repaying principal in full to the insurer on a date certain;
  - *Illustration* – A security that incorporates the performance of other assets to determine contractual payments, principal or interest, either directly or indirectly through references to asset pools, equity baskets, or non-interest rate indices.
  - *Illustration* – A security that receives payments as the remainder or residual cashflow after all other payment obligations have been made.
  - *Illustration* – A security that receives performance or bonus cashflows in addition to scheduled payments of principal and interest.
  - *Illustration* – A security with no contractual events of payment default.
- 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

36. 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**.

37. 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.

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:

   …

   - **Securities with Other Non-Payment Risks** – As noted in Parts One and Two of this Manual, the regulatory assumption of a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A security that is inconsistent with this assumption contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/04 - Other Non-payment Risk subscript S/2021-047.01 Task Force 2021 Amend PP Other Non-Payment Risk.docx

Mike Monahan
Senior Director, Accounting Policy
202-624-2324 t
mikemonahan@acli.com

February 10, 2022

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

Re: Amendment to the P&P Manual to update the definition of Other Non-Payment Risk assigned a Subscript S

Dear Ms. Mears,

The American Council of Life Insurers ("ACLI"), Private Placement Investors Association ("PPIA"), and North American Securities Valuation Association ("NASVA") ("the undersigned") appreciate the opportunity to engage with state regulators and the NAIC on the SVO's proposed Amendment to the P&P Manual to update the definition of Other Non-Payment Risk assigned a Subscript S.

The Proposed Amendment proposes the following two distinct additions to the P&P Manual:

1) The proposed addition of Subscript S securities (collectively) to the list of securities explicitly noted to be non-eligible for filing exemption in the P&P Manual, and
2) The proposed addition of four illustrations to the definition of Subscript S securities with other non-payment risk.

The undersigned offer the following comments on these proposals. For the purposes of brevity, we will not repeat our comments made in our letter of the same date, on the Proposed Amendment to

the P&P Manual to update the definition of Principal Protected Securities (PPS), as we believe the two proposed amendments are highly interrelated. The undersigned respectfully request readers to read that letter first to understand the full context of our comments below.

1) Subscript S securities are already not eligible for filing exemption, and the Subscript S proposed amendment, recommends collectively and explicitly adding Subscript S securities to the list of non-filing exempt securities. The undersigned support this proposal, in concept, because we believe they were inadvertently left off the list due to a historical oversight. As such, collectively adding Subscript S securities to the list of securities not eligible for filing exemption will improve the clarity and usability of the P&P Manual.

2) Prior to adding Subscript S securities to the list of non-eligible filing exempt securities, we recommend the following four steps:
   i. Add the PPS definition, as currently written in the P&P Manual, to the list of illustrations (i.e., examples) already included under Subscript S definition. See also our letter, referred to above, related to PPS as well as our comments included below for more context.
   ii. Remove PPS from the list of securities not eligible for filing exemption, consistent with other examples of Subscript S securities. See also our letter, referred to above, related to PPS for more context.
   iii. Define separately the new concern related to PPS as a separate illustration (example) within the Subscript S definition. We believe trying to layer on this concern, atop the PPS definition, will make the already current and complex PPS definition, potentially unworkable. Further, it appears at least some of proposed four new additions to the Subscript S definition are already an attempt by the SVO to do so. The concern should only be addressed in one spot to ensure as much clarity and usability in the P&P Manual as possible. See also our letter, referred to above, related to PPS.
   iv. The proposed amendment also includes four additional illustrations to the Subscript S definition without any context for their proposed inclusion. We understand at least some of these proposed new additions are related to concerns with PPS-like securities created by means other than that illustrated within the PPS definition. There is widespread confusion among the undersigned's constituency as to what specifically the SVO is trying to address with the four examples, but more importantly, what do they all potentially capture by way of unintended consequences. We therefore propose that we jointly work with the SVO, to more fully understand the explicit concerns, so we can jointly address those concerns and importantly ensure continued clarity and usability of the P&P Manual – consistent with the other examples included within Subscript S.

We discussed these concepts with Charles Therriault, and his team, and suggested we would like to work with the SVO to address this matter in the most efficient way possible. Our understanding is Charles and team are amenable to this suggestion.

We look forward to working with the SVO and regulators on this issue.

Sincerely,

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey

Tracey Lindsey
NASVA

John Petchler

John Petchler
on behalf of PPiA
Board of Directors

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: Update the Definition of Other Non-Payment Risk Assigned a Subscript "S" in the P&P Manual

DATE: July 8, 2022

Update – At the 2022 Spring National meeting the SVO was directed to work with industry on technical modifications to this proposed amendment that was first exposed at the 2021 Fall National Meeting. The SVO met with representatives of the American Council of Life Insurers (ACLI), Private Placements Investors Association (PPiA) and North American Securities Valuation Association (NASVA) on Apr. 29, May 6 and 24, and Jun. 17. The attached revised amendment reflects items discussed during those meetings. There was not consensus on three primary issues, each a proposed illustration of 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 adopting the definitional updates to Part Two of the P&P Manual and temporarily deferring the proposed Part Three instructions to remove securities with Other Non-Payment Risk from filing exemption (FE). This temporary deferral is intended to give industry sufficient time to find and provide examples of securities that are publicly rated by different credit rating providers (CRP) which have the three characteristics listed above for which there was not consensus so that the SVO can study them.

Summary – Securities that possess "Other Non-Payment Risks" are intended to be reviewed by the SVO but these investments have not been explicitly included on the list of Specific Populations of Securities Not Eligible For Filing Exemption in Part Three of the *Purposes Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). Securities with other non-payment risks are identified through assignment of the Administrative Symbol "S" as a subscript to the NAIC Designation. This amendment adds "Securities with Other Non-Payment Risks" to the list of securities that are ineligible for filing exemption.

As noted in Part One, paragraph 90, of the P&P Manual, "*An objective of the VOS/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification*

that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is required to identify securities that contain such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer, so this can be reflected in the NAIC Designation assigned to the security through the application of the notching process."

The proposed amendment clarifies through additional illustrations the types of securities that would be considered as having "Other Non-Payment Risks".

Proposed Amendment - The text changes to update the definition of "Other Non-Payment Risks" and include Securities with Other Non-Payment Risk as a security type ineligible for filing exemption is shown below with additions red underline, deletions in ~~red strikethrough~~, existing text that has been moved in green and text to defer in yellow highlight, as it would appear in the 2022 P&P Manual format.

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

NAIC DESIGNATIONS

. . .

NAIC Designation Subscript S

90. An objective of the VOST/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is required to identify securities that contain such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer, so this can be reflected in the NAIC Designation assigned to the security through the application of the notching process.

NOTE: See "NAIC Designation Subscript S" in Part Two.

…

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS
APPLICABLE TO THE SVO

PRODUCTION OF NAIC DESIGNATIONS

…

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;
  - *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 date~~s~~ (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.
- The governing agreements permit irregular or conditional payments that are incompatible with the notion of an issuer making scheduled payments of interest and repaying principal in full to the insurer on a date certain;
  - ~~*Illustration* – A security that incorporates the performance of other assets to determine contractual payments, principal or interest, either directly or indirectly through references to asset pools, equity baskets, or non-interest rate indices.~~
  - ~~*Illustration* – A security that receives payments as the remainder or residual cashflow after all other payment obligations have been made.~~
  - ~~*Illustration* – A security that receives performance or bonus cashflows in addition to scheduled payments of principal and interest.~~
  - *Illustration* – A Principal Protected Security, as defined in Part Three of this Manual.
  - *Illustration* – A security with no contractual events of payment default.
  - *Illustration* - ~~Insurer agrees to an exposure that has~~ A security with contractual terms that have the potential to result ~~a significant delay~~ in payment of contractually promised interest and/or return of principal in an amount less than the original investment.
  - *Illustration* – A security with deferred principal payment features that are at the option of the issuer, not including grace periods of up to 30 calendar days.
  - *Illustration* – A security with interest payment deferral feature that does not capitalize interest into principal or permits interest deferral for greater than twelve months or past legal maturity.

- ~~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

37. 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**.

38. 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.

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:

…

Deferred

- **Securities with Other Non-Payment Risks** – As noted in Parts One and Two of this Manual, the regulatory assumption of a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A security that is inconsistent with this assumption contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/04 - Other Non-payment Risk subscript S/2021-047.01 Task Force 2021 Amend PP Other Non-Payment Risk.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: Risk Assessment of Structured Securities - CLOs

DATE: May 25, 2022

Introduction - A collateralized loan obligation (CLO) is type of structured security 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.

There are two general types of tranches: debt tranches and equity tranches. Debt tranches are treated just like bonds and typically have credit ratings and coupon payments. Between the debt tranches there is a priority of payments, called a waterfall, by which senior debt tranches are paid before junior, or mezzanine, debt tranches. Equity tranches typically do not have credit ratings and are paid out after all debt tranches on a periodic basis.

Regulatory Issue – 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.

It is currently possible to materially (and artificially) reduce C1 capital requirements just by securitizing a pool of assets. This is best illustrated through the following example. Investment A is a pool of corporate loans that would typically comprise a CLO and have a credit rating provider (CRP) rating of 'B'. At a 'B' rating level these investments would be mapped automatically through the Filing Exemption process to an NAIC Designation of NAIC 4.B and receive an RBC factor of 9.535%. Putting those same 'B' rated corporate loans into a CLO divided into six tranches rated AAA, AA, A, BBB, BB and equity, and an insurer buys all of those tranches would result in an overall RBC factor of 2.917%, an RBC arbitrage benefit of +6.618%.

Investment A

Direct investment in a portfolio of 'B' rated loans (NAIC 4.B)

Bond Rating	RBC Factor
AAA (1.A)	0.158%
AA (1.C)	0.419%
A (1.F)	0.816%
BBB (2.B)	1.523%
BB (3.B)	4.537%
B (4.B)	**9.535%**
CCC (5.B)	23.798%

Investment B

Securitize those same loans into a CLO and hold the entire transaction

Tranche Rating	Tranche Size	RBC Factor
AAA (1.A)	63.0%	0.158%
AA (1.C)	12.0%	0.419%
A (1.F)	6.0%	0.816%
BBB (2.B)	6.0%	1.523%
BB (3.B)	5.0%	4.537%
B (4.B)	0.0%	9.535%
CCC (5.B)	0.0%	23.798%
Equity	8.0%	30.000%
Total	**100.0%**	**2.917%**

Investment	RBC Factor
Investment A	9.535%
Investment B (all tranches)	2.917%
RBC Arbitrage Benefit	**6.618%**

Investments A and B:

- Both have the same earnings (less structuring fees) and market value.
- Both have the same economic risk.
- Investment B require about 1/3 the regulatory capital because it is a securitization and how they are rated.

Recommendation - The capital required for holding all tranches of a structured security should be consistent with the capital required when holding all of the underlying collateral. As the example above illustrates, there is a significant RBC arbitrage opportunity available today because of the ratings process and the NAIC's RBC factors. The Structured Securities Group (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 eliminate the RBC arbitrage. Highlights of the proposed modeling approach are listed in Appendix A.

The Valuation of Securities (E) Task Force can initiate and approve the assignment of NAIC Designation Categories to CLOs modeled by SSG to eliminate this RBC arbitrage. The Investment Analysis Office staff recommends the Task Force approve staff's request to draft an amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* permitting SSG to model CLO investments.

Staff also recommends the Task Force direct referrals to the Capital Adequacy (E) Task Force (CATF) and its Risk-Based Capital Investment Risk and Evaluation (E) Working Group (RBCIREWG) to request that those groups consider adding two new RBC factors. These new RBC factors can account for the tail risk in any structured finance tranche. Staff suggests adding NAIC Designation Categories (e.g. 6.A, 6.B and 6.C). with recommended RBC factors of 30%, 75% and 100%, respectively.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/00 Work in Progress/CLOs included in Part Four/2022-XXX.XX - Risk Assessment of Structured Securities - CLOs v2.docx

Appendix A

Modeling:

- Starting with the general approach set forth in the CLO Stress Test Methodology, SSG can make the following modifications:
    - Add multiple (8-12) probability weighted scenarios.
    - The probabilities will be derived via an arbitrage free approach such that the ∑(asset risk) = ∑(tranche risk) based on current RBC factors.
    - Since tranche performance is non linear, practically this means that SSG can look at a batch of typical deals and set probabilities: ∑(asset risk) = ∑(tranche risk) ± 10% or so.
- The process will be transparent and be reviewed periodically.

Regulatory approach:

- Follow the current RMBS/CMBS approach.
- Annual assessment at year end.
- Publish designations / breakpoints via AVS+ (or similar)

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-06-09 - Interim Meeting/05 - CLOs included in Part Four/2022-004.01 - Risk Assessment of Structured Securities - CLOs v3.docxIAO designations must be used for YE reporting

Attachment Ten – A
Valuation of Securities (E) Task Force
8/11/22

Staff Discussion of Responses to CLO Proposal

2022 Summer National Meeting

August 11, 2022
Portland, Oregon

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Introduction

- At the June 9th meeting, VOS (E) TF exposed a memo calling for an internal modeling of CLOs as well as extended Designation Categories (6.A, 6.B and 6.C).
- We have received eight responses from the following parties:

Party	Descriptiom
ACLI	Life Insurance trade association
AIC	Private Equity trade association
Athene	Insurance company
EJR	Rating agency (N.B. EJR's CLO ratings are not CRP-eligible).
LSTA	Commercial loan origination, syndication and trading trade association.
PineBridge	Asset manager
SFA	Structured Finance trade association.
TIAA/Nuveen	Insurance company

Summary of the Concerns

- Responses are best summarized as cautious. Some responses were supportive with caveats. Most of the other responses expressed concern with the proposal or its implications. Their concerns are best categorized as follows:
  1. Timeline. Respondents were concerned about the timeline of the proposal as well as an opportunity for comment.
  2. Policy Arguments. These sought to appeal to the importance of CLOs to the US capital markets and the historical performance of the asset class.
  3. Transparency.
  4. Methodology.
- Today, we will deal with the first two issues, since staff believes that there will be many opportunities to make and deal with transparency and methodology.

Big Picture Responses

- We acknowledge that the historical performance of CLOs has been excellent weathering three economic downturns - dotcom bubble, GFC and COVID. The goal of the proposal is to balance the risks to ensure that CLOs continue to be an investment option for insurers.
- If the proposal is approved, there will be many more opportunities to comment on all elements of the proposal, including on process, methodology, scenarios and probabilities.
- The process is intended to be maximally transparent – market participants should be able to replicate our results.
- When evaluating the proposal, especially with respect to RBC, the proper frame of reference is the investments held by and constraints on insurance companies.
- CLOs account for 60% of all leveraged loans. In addition, the non-CLO loans are often managed (in other forms) by the same managers who manage CLOs. Given this footprint, it is difficult to dissociate the performance of the CLO loans from the broader loan market.

Policy: Importance of CLOs and Loan Markets

- ***Issue:*** A number of participants appealed to the importance of CLOs to the financial markets.

- ***NAIC Staff Response:*** Regulators and staff appreciate the role of insurance companies and their investments in the U.S. economy and financial markets. Nevertheless, the main priority of state insurance regulation are policyholders and ensuring that they are protected through prudent financial solvency policies.

Policy: Historical Performance of CLOs

- ***Issue:*** CLOs have had a stellar historical performance, therefore no regulatory action is required.

- ***NAIC Staff Response:*** The historical performance of CLOs has indeed been good. This is especially true for the top of the CLO capital stack. Senior CLO tranches have performed extremely well through three economic downturns – dotcom bubble, GFC and COVID.

  The actions contemplated are designed to allow insurers to continue participating in the CLO market without the risk that aggressive structuring puts the policyholders and the investments in jeopardy.

Timeline and Opportunity to Comment

- ***Issue:*** A number of respondents were concerned about how quickly this change may be implemented along with having an opportunity to comment.

- ***NAIC Staff Response:*** Staff expects there will be ample opportunity for comment from interested parties as regulators consider this proposal. The NAIC process is very deliberative and open to constructive feedback during deliberation . Below is staff's estimated timeline :
  - Expose for comment proposed P&P amendment(s): late 2022
  - Methodology (excluding-scenarios): late 2022 to early to mid 2023
  - Scenarios/Probabilities and RBC tie out: 2023 – this step is likely to be the most interactive
  - Final implementation: 12/31/2023 (at the earliest) and 12/31/2024 (most likely)
- Staff is open to working with interested parties as well as providing information

sessions for a larger audience.

Conclusion

- Staff recommends that VOS proceed with the proposal. Specifically,
  1. Refer the RBC issue to the RBCIRE
  2. Direct staff to draft P&P language for exposure
  3. Direct staff to work with interested parties to fine tune methodology; and to draw up scenarios / probabilities

Other Methodology Responses

Transparency

- ***Issue:*** Several participants requested that the NAIC provide transparency into the potential results.

- ***NAIC Staff Response:*** We plan to provide complete transparency into the modeling process. Specifically for BSL CLOs, an insurer with access to modeling software (Intex, Moody's, Trepp, etc) and relevant Trustee report –should be able to tie-out with our numbers.

  Furthermore, staff believes that any investor in mezzanine tranches must be able to perform this level of analysis to support their investment decision.

- Additionally, because the process is intended to be completely transparent and considering that insurers, as an industry, possess considerable CLO expertise, staff does not believe that a 3rd party is required.

Tail Risk

- ***Issue:*** Staff have not justified the need for RBC at the 75% and 100% level.

- ***NAIC Staff Response:*** Currently, for certain non-legacy RMBS and CMBS, an Intrinsic Price ("IP") is computed. The IP is then compared to the mid-point of the RBC scale. For example, a security with an IP of above 99.786 is assigned a Designation Category of 1.A.

  This system works quite well, unless the IP is below 70, since the highest RBC possible is 30%. Fortunately, this occurs exceedingly rarely. For example, immediately after the GFC, a mezzanine RMBS tranche was evaluated with an IP of 5. The tranche was held at par by the insurer and as a result, the resulting RBC was far below the risk evaluated. The other situation where this can occur is in residual tranches, such as CLO equity, where there is no principal or interest promise while cash flows may be interrupted to

protect senior tranches.

Methodology: General

- The methodological approach, if adopted, will be similar to Moody's approach philosophically.
  - However, it is not anticipated that the number or the probability of scenarios will be dictated by the binomial distribution. Instead, both will be used to tune the RBC equivalence.
- Discounting, IPs and mapping to Designation Categories is expected to be similar to the current process for RMBS / CMBS
- Lastly, when making methodology arguments, staff would appreciate if respondents discussed how the issue is handled by other market participants, including NRSROs (with specific cites to published methodologies or similar).

Methodology: Diversification

- ***Issue:*** CLOs are diversified pools of loans, and that benefit should be reflected.

- ***NAIC Staff Response:*** Within the RBC framework: RBC already assumes some level of diversification. As one respondent points out, the Portfolio Adjustment Factor can reduce the RBC for sufficiently large portfolios. On the other hand, there is a penalty for smaller portfolios. We recommend the directions are read carefully.

- Within the CLO, diversification does not provide a direct benefit to the pool of loans. Specifically, it does not change the cumulative probability of default of the pool, it changes the shape of the cumulative default curve – reallocating the risk among the various tranches.

Methodology: Structure / Waterfalls

- ***Issue:*** CLOs benefit from structures which divert cashflows in case of distress.

- ***NAIC Staff Response:*** Staff is of the view that the excellent historical credit performance of CLOs relies primarily on the combination of effective overcollateralization tests (OC) and sizable excess spread. These mechanisms deleverage the transaction until the OC tests are in compliance.

  The intention of the proposal is for SSG to model each transaction, these structures will be explicitly accounted for.

Methodology: Portfolio Constraints

- ***Issue:*** CLO portfolios are constrained by various collateral quality tests, including those related to ratings and diversification.

- ***NAIC Staff Response:*** The collateral quality tests described are typically "trading rules" - that is, failure shuts off some of the manager's trading ability. Furthermore, they are usually framed as "maintain or improve" – a manager of a CLO which is failing a test can still trade if the test does not worsen. Unlike the functionality of the OC tests, these tests do not cause the deal to de-lever (with the notable exception of CCC/Caa haircuts). Furthermore:
  - Investments held by insurance companies are also bound by a number of legal and contractual restrictions.
  - Since the intention of the proposal is for SSG to model the exact portfolios explicitly, the constraints are not relevant.

Methodology: Active Management

- ***Issue:*** "CLOs are actively managed by professional asset managers with teams of portfolio managers, credit analysts, risk managers, and operations personnel."

- ***NAIC Staff Response:*** First, insurance company loan portfolios are also "managed by professional asset managers with teams of portfolio managers, credit analysts, risk managers, and operations personnel." In some cases, these are internal resources – a number of large CLO managers began or grew out of insurance company asset management arms. In others, the outsourced managers are the very same who manage CLOs. This alone does not justify an RBC benefit for CLO pools.

  Second, staff is open to robust studies showing that the performance of loans in CLOs is better than the market as whole. Nevertheless, we are skeptical that there exists a pool of loan investors outside of CLOs which would be willing to absorb distressed loans at advantageous prices.

Methodology: Portfolio Selection

- ***Issue:*** CLO managers select loans which perform better than the market as a whole. One participant produced a graph comparing Moody's default rate with realized default rates in CLOs.

- ***NAIC Staff Response:*** Staff is skeptical but open with respect to this issue. The skepticism stems from the large percentage of all leveraged loans in CLOs. The graph submitted is not helpful since it appears to describe the percentage of loans which default while still held by the CLO. CLOs are actively managed and managers often sell loans prior to default. In this case, the impact of default is reflected in the sale price.

  Staff believe that a cohort/ratings-based study comparing the default performance of loans in CLOs vs. broader markets would be helpful. For example, comparing the default rate of all the B1 loans listed in the first trustee report of each year to the equivalent Moody's cohort (formed on Jan 1 of each year).

Methodology: Par Trading

- ***Issue:*** In times of distress, managers can buy loans at a discount to build subordination in the CLO. The impact of this trading should be modeled.

- ***NAIC Staff Response:*** Staff believes that this effect should not be modelled. A loan purchased at a price above a specific threshold ("discount purchase") is counted at full par for the purposes of OC tests. This allows the manger to stop deleveraging and build par. This tactic has served CLOs well in the past three downturns where the price dislocation was due to liquidity (not credit) and with a little help from the Federal Reserve. However, this does incentivize managers to purchase loans which are truly distressed. As Moody's noted with respect to CBOs:

  "Much of the portfolio under-performance can be attributed to industry concentration …and an "aggressive" investment philosophy. By "aggressive", we refer to the purchase of the cheapest assets for a given rating which, in the recent deteriorating credit environment, resulted in more severe portfolio deterioration."

Moody's, U.S. High-Yield CBOs: Analyzing the Performance of A Beleaguered CDO Category, January 31, 2003

July 15, 2022

VIA ELECTRONIC SUBMISSION

Ms. Carrie Mears, Chair
Mr. Doug Stolte, Vice Chair
Valuation of Securities Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Comments regarding the IAO Issue Paper on the Risk Assessment of Structured Securities - CLOs

Dear Ms. Mears and Mr. Stolte:

The American Investment Council ("AIC")[1] appreciates the opportunity to comment on the National Association of Insurance Commissioners ("NAIC") Valuation of Securities Task Force (the "Task Force") exposure, *IAO Issue Paper on the Risk Assessment of Structured Securities - CLOs* (the "Issue Paper"). As the advocacy, communications, and research organization for the world's leading private equity and private credit firms, which have substantial experience assisting insurers with their investment needs, we believe we are well-positioned to share an important perspective with the NAIC.

[1] The American Investment Council, based in Washington, D.C., is an advocacy, communications, and research organization established to advance access to capital, job creation, retirement security, innovation, and economic growth by promoting responsible long-term investment. In this effort, the AIC develops, analyzes, and distributes information about private equity and private credit industries and their contributions to the US and global economy. Established in 2007 and formerly known as the Private Equity Growth Capital Council, the AIC's members include the world's leading private equity and private credit firms which have experience with the investment needs of insurance companies. As such, our members are committed to growing and strengthening the companies in which, or on whose behalf, they invest, to helping secure the retirement of millions of pension holders and to helping ensure the protection of insurance policyholders by investing insurance company general accounts in appropriate, risk-adjusted investment strategies. For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

We support the Task Force's mission of providing regulatory leadership and expertise to establish and maintain all aspects of the NAIC credit assessment process for insurer-owned securities. We also understand the need to review capital charges associated with collateralized loan obligations ("CLOs") – particularly in light of the growth in this market segment and the structural changes that have taken place since the 2008-2012 global financial crisis – and the need to understand the risk. To that end, we welcome the opportunity to serve as a resource to the Task Force as it considers the proposals (the "Proposals") submitted by the NAIC Investment Analysis Office ("IAO") to amend the NAIC *Purposes and Procedures Manual of the NAIC Investment Analysis Office* ("P&P Manual") to remove CLOs from Filing Exempt Status[2] and permit the NAIC Structured Securities Group to model the RBC Designation Categories for CLO investments.

If adopted, the Proposals would extend the current approach for RBC Designations of residential mortgage-backed securities ("RMBS") and commercial mortgage-backed securities ("CMBS") to RBC Designations for CLOs under the presumption that doing so would eliminate so-called "RBC arbitrage" that arises from holding a pool of loans versus holding individual tranches of a CLO, in which such loans have been securitized. Specifically, the Proposals suggest that the aggregate RBC factor for owning all tranches of a CLO should be the same as that required for holding each of the underlying loans. Therefore, the Proposals would be expected to result in certain CLO tranches carrying a higher capital charge than their NRSRO ratings currently assign. We do not believe that a higher capital charge is an appropriate outcome, nor would it appropriately characterize the actual risk associated with CLOs.

As explained in further detail below, the Proposals are a significant departure from the current framework and, if adopted, would have far-reaching and substantial consequences on the insurance industry and capital markets. The Proposals are unclear as to whether their underlying rationale– i.e., the implied presumption that CLOs or certain CLO tranches are inherently riskier than their current capital charges – takes into account the strong historical performance of CLOs (e.g., as described in more detail below, CLOs have substantially lower default rates than comparably rated corporates) or the structural benefits and investor protections that modern CLOs provide to investors.[3]

As the Task Force continues its review of the Proposals, we would encourage an open and transparent process. Given the potentially significant ramifications of the

[2] Filing Exempt Status generally permits insurers to utilize credit ratings of nationally recognized statistical rating organizations ("NRSROs") in certain instances for purposes of determining the proper NAIC designation category and the associated Risk-Based Capital ("RBC") factor.

[3] We also note that, if approved, the Proposals would appear to transfer certain modeling and rating responsibilities to the SSG, and we are concerned that the Issue Paper does not sufficiently address a number of issues – including modeling and rating governance and the opportunity for public comment – that should be resolved prior to taking such action.

Proposals, the Task Force's involving the relevant stakeholders in this process is critical, including as it relates to the opportunity to comment on the Issue Paper, the Proposals, and any future proposed RBC factor changes. Furthermore, we encourage the Task Force to engage an independent consultant with substantial capital markets experience to provide greater technical analysis (including an objective assessment of CLO risk profiles, insurers' investments in CLOs, and the potential impact proposals of this magnitude could have on the insurance industry and US businesses more broadly) prior to adopting the Proposals.

We believe the following information is paramount for the analysis and evaluation of the Proposals and appreciate you taking it into consideration.

I. Modern CLOs Have Numerous Structural Benefits and Investor Protections

Under the current system, NRSROs evaluate transactions in a consistent manner based on detailed criteria that is publicly available and regulated by the United States Securities and Exchange Commission ("SEC")[4]. Among other things, that evaluation accounts for numerous CLO features (detailed below) in determining the rating of CLO tranches. Each CLO tranche is rated and receives an RBC charge that corresponds to the underlying credit and structural risk on such tranche, with the equity (first loss) residual having the same charge as an investment in common equity and other equity interests generally. Recent reports and studies also conclude that other equity investments have similar risk profiles to, if not more adverse than, the risk profile of CLO equity.[5] Therefore, it is wholly appropriate for CLO equity to be treated the same as other forms of equity.

Nevertheless, the stress modeling approach outlined by the Issue Paper would require CLO equity RBC factors to increase materially, with some recent models (conducted in response to the Issue Paper) indicating that the RBC factor for CLO equity would need to increase to 75%-100% to achieve the Proposal's objective.[6] Such an outcome is significantly misaligned with the actual performance of CLO equity. For example, the median equity internal rate of return for redeemed CLO equity deals that were issued during the global financial crisis between 2005 and 2007 were higher than 20%, and for deals issued in 2020 were higher than 40%.[7]

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[4] NRSROs are registered with and subject to the oversight and supervision by the SEC.

[5] *See, e.g.*, Bank of America Securities CLO Weekly, 8 July 2022 *available at*: https://rsch.baml.com/access?q=iFp-!Um2FVU52HHJ2iTm6w.

[6] *See*, Citi, US Insurers' CLO Investments May Face a Spike in Capital Charge, July 2022.

[7] *See,* Bank of America Securities CLO Weekly, 8 July 2022. We also note that the aforementioned RBC factor change in respect of CLO equity would be in addition to RBC factor changes that would be necessary to the BB and/or BBB tranches of CLOs in order to achieve the Proposal's objective.

In addition, the Issue Paper suggests that the aggregate RBC factor for owning all tranches of a CLO should be identical to that which is required for holding each of the underlying loans. Such a methodology does not accurately account for the numerous benefits of securitization that have led to CLO tranches – including below-investment grade tranches – experiencing lower impairments than equivalently rated corporates.[8] There are important factors that need to be assessed on a tranche-by-tranche basis: (i) diversification within the collateral pool, (ii) excess spread[9] payable to CLO debt and equity holders; (iii) active management; (iv) collateral quality tests; and (v) overcollateralization; and (vi) priority of payments waterfalls. It is important to note, for example, that the risk profile and economic outcomes of the individual tranches of a CLO will be different than if, for example, an investor solely held single-B rated loans, as assumed in the Issue Paper's proposed modeling approach. These factors are described in greater detail below.

- Diversification. CLOs impose and enforce diversification within the structure. The diversification requirement is crucial to understanding the riskiness of the product, because the probability of losses in holding a CLO tranche of a certain rating level is significantly reduced in comparison to holding a single loan of the same rating level.[10] The collateral pool itself is comprised of loans in uncorrelated industries – this further reduces credit risks because the exposure in the CLO tranches is uncorrelated, and as a result this further helps protect an investor as compared to investing in a single loan of comparable rating.[11] NAIC RBC C1o currently accounts for diversification for publicly traded corporate debt through the portfolio adjustment factors process. At a minimum, a similar diversification adjustment factor should be applied to the collateral pools in a

[8] *See* Analysis of Historical NRSRO Ratings Data (Morgan Stanley, February 2022), *available at:*https://mcusercontent.com/65ee38c99561aeba4a1f82919/files/ff9650b4-dfa7-2815-f41afa7a60d85fbf/Final_Morgan_Stanley_Report_18_.pdf; *see also* Moody's Annual Default Study (February 2022); Moody's Semi-Annual Performance Statistics Update (August 2021); S&P Annual Global Structured Finance Default and Rating Transition Study (May 2021); Moody's Impairment and Loss Rates of Global CLOs (June 2021).

[9] "Excess spread" is the surplus difference between the interest received by a CLO issuer from the underlying loans and the interest paid to the CLO debt holders.

[10] This has been demonstrated through objective data analysis. *See* The US CLO Market (LSTA, April 2022), *available at*: https://www.lsta.org/content/the-u-s-clo-market-white-paper/.

[11] This diversification is generally governed by indenture rules around individual issuer and sector concentration limits. Specifically, rating agencies and investors require every CLO to maintain a high level of corporate sector diversity within its portfolio. CLOs include formal "single name limits," that limit any single borrower exposure (e.g., 1-2% max per obligor) and "industry limits" that prevent one industry from representing too great a concentration (e.g., 10-12%, sometimes with exceptions up to 15%) of underlying assets.

CLO. If applied to the 200 or more loan issuers in each CLO's collateral, the portfolio adjustment factors ("PAF") formula[12] would reduce the RBC charge by 15% to 20%.

- Active Management. Unlike a static pool of loans, CLOs are actively managed by professional asset managers with teams of portfolio managers, credit analysts, risk managers, and operations personnel. A CLO manager may purchase new assets with proceeds received from the prepayment or scheduled amortization of loans in the existing portfolio, which are subject to strict eligibility criteria and collateral quality tests. This helps to maintain and/or improve the credit quality of the portfolio. CLO managers may also engage in a certain amount of discretionary trading and trade "credit risk" or "credit improved" loans to optimize portfolio quality in real time.[13] In addition, CLO managers have the ability and are incentivized to sell loans out of the structure before default or a material price deterioration. As explained recently by the Loan Syndications and Trading Association, active management thus allows CLO investors to avoid the defaults it might otherwise experience if it passively held the underlying loans directly.[14] Specifically, CLO historical average defaults (<0.1%) were much lower than bank loan historical defaults of 1%-2%.[15]

- Overcollateralization. This important feature ensures the value of the underling pool of collateral exceeds the principal value of the CLO debt tranches. The overcollateralization requirement of CLOs provides protection to CLO debt holders if ratings migration of the underlying pool of loans deteriorates in excess of the applicable threshold amount, which typically limits the amount of "CCC" rated underlying loans to 7.5%.

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[12] Life insurers must apply to all their holdings the adopted MA base RBC C1 bond factors and PAF derived solely from public corporate holdings. They multiply their portfolio weights for each NAIC designation by the associated bond factor to develop a pre-tax capital charge for that designation. A post-tax capital charge is then derived from the pre-tax factor. Finally, all post-tax capital charges are summed. A PAF is derived based on the number of issuers in the insurer's holdings and that PAF is multiplied by the post-tax capital charges to create the C1o for use in the NAIC RBC formula.

[13] Managers are able to achieve alpha and, importantly, avoid losses (thus reducing risk), as compared to a passive pool of loans by (a) selling potential defaults before their loan prices decline significantly and (b) buying distressed loans at discounts when market conditions become challenging, effectively building subordination to support the liabilities.

[14] *See* CLOs: NAIC-scent challenges (LSTA, June 2022), *available at*: https://www.lsta.org/news-resources/clos-naic-scent-challenges/. *See also* Bank of America Securities CLO Weekly, 24 June 2022 ("an actively managed vehicle drives lower implied defaults/losses in CLO portfolios vs historical defaults in the loan market.").

[15] *Id*.

- Waterfalls. If cash flow on the underlying pool of loans deteriorates, under the terms of a CLO, it can result in a failure of the CLO's overcollateralization ratio test, whereby the CLO structure will retain (or "trap") cash (as opposed to distributing it through the waterfall to subordinate tranches), and use this cash to de-lever the senior CLO tranches.[16]

II. RMBS/CMBS Approach Is Not a Suitable Model for CLOs

The factors described above are unique to CLOs and are distinguishable from the structures for RMBS/CMBS. Furthermore, the different historical context for the RMBS/CMBS approach should be accounted for when considering whether to apply the same approach to CLOs. Importantly, in 2009, SVO modeling for RMBS/CMBS was driven by negative credit ratings migration experienced by RMBS/CMBS during the 2009 housing crisis that caused a potential solvency crisis for the insurance industry. At that time, insurance regulators and the industry understood that insurance companies often held higher tranches of these investments. As a result of the housing crisis and the overall financial crisis, many of the RMBS assets were downgraded by NRSROs. The downgrading actions in the lower tranches impacted the NRSROs' approach to rating all tranches of these investments, including higher tranches, which also experienced substantial downgrades. As a result, insurers' RBC plummeted.[17] These circumstances appropriately caused regulators to seek to change the way RMBS and ultimately, CMBS, were evaluated for statutory accounting purposes.

Notably, however, and importantly, this dynamic does not exist today *vis-à-vis* CLOs. No such market volatility related to CLOs exists which would justify the proposed RBC change for CLOs. As explained below, the structure and performance of CLOs bears no relation to that of RMBS and CMBS, and should not be treated the same

[16] We recognize that this may be to the economic disadvantage of residual tranches of CLOs. However, we respectfully note that: (i) as discussed in Section I above, it is appropriate for CLO equity to be treated the same as other forms of equity; and (ii) the Issue Paper seems to imply unrealistic outcomes for mezzanine and other CLO tranches. As Bank of America notes, "The impact of the proposal will likely primarily be felt in BBB and below rated bonds. This may result in a significant disconnect wherein higher rated CLO bonds which have historically displayed little to no losses, are faced with an RBC factor similar to corporates that are rated at least 3-5 notches lower. *See* Bank of America Securities CLO Weekly, 24 June 2022.

[17] According to the NAIC, continued reliance on NRSRO ratings for year-end 2009 designations would have resulted in a nearly six-fold increase in life insurers' RBC for mortgage-backed securitizations, and RBC charges would have increased from about $2 billion to more than $14 billion. *See*, Financing Home Ownership: Origins and Evolution of Mortgage Securitization Public Policy, Financial Innovations and Crises (NAIC and The Center for Insurance Policy and Research, August 2012), *available at*: https://content.naic.org/sites/default/files/inline-files/cipr_120812_white_paper_financing_home_ownership.pdf

way. Moreover, unlike the case with RMBS/CMBS, the Proposal could be expected to have a negative impact on insurers' capital and surplus (especially given there is no grandfathering contemplated by the Proposal), which is at odds with the purpose of the RMBS/CMBS model initiative. Further consideration and analysis should be given before concluding that an actual fundamental modeling of the underlying loans (and not simply adjusting the structure based on underlying assets) is the proper course of action with respect to CLOs.[18]

III. CLOs Have Performed Very Well for Decades

Unlike RMBS and CMBS during the financial crisis, CLOs have historically – and continue – to perform well. Along with the performance of CLOs, it is significant to note that studies conclude that CLO default rates are substantially lower than default rates for corporates with equivalent ratings[19]. In fact, studies indicate that the number of cumulative losses that would have had to occur in respect of the loans underlying CLOs for CLOs to have suffered significant defaults during the 2008-2012 financial crisis is significantly higher than what actually occurred during such time (assuming a reasonable recovery rate), thus demonstrating the durability of, and differentiated outcomes related to, CLOs.[20] Even single B tranches of CLOs have out-performed their equivalently rated corporates during this period (single B CLOs have experienced 0.66% impairments in the past decade versus 1.28% for equivalently rated corporates).[21] CLOs have also historically recovered after economic downturns. For example, a recent study indicates that, as an asset class, CLOs had a strong rating and price recovery following the 2008-2018 global financial crisis.[22]

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[18] Furthermore, in 2009, insurance companies were not only supporting the reform in respect of RMBS (due to the RBC impact in the absence thereof), but the idea behind reform originated from the insurance industry and, in particular, the American Council of Life Insurers ("ACLI"), which approached the NAIC with proposals, and requested implementation of such change by year-end 2009. Here, there is no consensus around the need for a change to the RBC charge methodology related to CLOs, much less that the SSG is the appropriate body to design such a methodology.

[19] *See e.g.,* Analysis of Historical NRSRO Ratings Data (Morgan Stanley, February 2022).

[20] *See* Moody's Impairment and Loss Rates of Global CLOs (June 2021) at pp. 14-19 (Appendix I: List of CLO material impairments worldwide).

[21] *See* Moody's Investors Service, Impairment and Loss Rates of Global CLOs: 1993-2020 (June 3, 2021) in Excel Supplement Ex. 9 (annual average of 1-year CLO default rates); Moody's Investor Service, Annual Default Study (Feb. 8, 2022) at p. 36 Ex. 37 (annual average of 1-year corporate default rates).

[22] In particular, 95% of the downgraded AAA debt returned to AAA ratings and 88% of the previously investment grade rated debt returned to investment grade debt. *See*, Citi, US Insurers' CLO Investments May Face a Spike in Capital Charge, July 2022.

Notwithstanding its strong track record, the CLO market has also evolved since the financial crisis: post-crisis CLOs (generally referred to as "CLO 2.0") now include enhanced investor protections, and more robust NRSRO rating processes and requirements. Such protections and processes include: increased tranche subordination (i.e., higher rated tranches comprise a lower percentage of the overall structure, compared to pre-financial crisis CLOs), greater credit enhancement at each ratings level, shorter reinvestment periods, no call periods and maturity periods, and the ability to refinance CLO tranches. Modern CLOs are also less complex than prior products: Specifically, newly originated collateral pools are now limited to corporate loans and, to a lesser degree, bonds and structured finance products are no longer permitted in CLO portfolios.

IV. The 2020 Stress Test May Not Be Fit for Purpose

As you are aware, in 2020 the NAIC performed five stress tests on broadly syndicated loan CLOs held by US insurance companies at year-end 2019. In light of the pandemic, these stress tests included two extreme scenarios: one intended to replicate the conditions of the 2008-2012 global financial crisis, and one intended to replicate an even more severe recession (note that the NAIC did not view these two extreme scenarios as sufficiently likely to include in its most recent stress testing, which considers just three scenarios). Those extreme stress test scenarios adopted certain unrealistically negative assumptions, including that those periods of volatility cause prepayments to stop completely for the life of the loans, which is not borne out by market experience. In addition, the stress tests assumed a reinvestment price of par, which is extremely unlikely during a period of high volatility.

These conservative assumptions were unrealistic because CLO managers can use prepayment proceeds to reinvest in new loans at discounts, improving credit support to the CLO debt tranches. Nevertheless, even under these and other highly conservative assumptions, the NAIC's own stress tests found virtually no principal impairment of CLO tranches rated at or above the "A" level. We believe this further demonstrates that CLOs provide a risk-appropriate asset class that performs to the benefit of policyholders.

V. CLOs Benefit Insurers and Finance US SMEs

As of 2020, insurers own approximately $200 billion[23] of CLO securities, a vital source of capital to US small and medium sized businesses. Specifically, CLOs represent over 60% of the financing for syndicated leveraged loans, a $1.4 trillion market that

[23] *See* Capital Markets Special Report (NAIC, 2021), available at https://content.naic.org/sites/default/files/capital-markets-clo-special-reports-ye-2020.pdf.

provides financing to thousands of US companies.[24] By design, any downgrade in the RBC treatment of CLO tranches, including the lower tranches, would disincentivize insurance companies to invest in those securities. This is notable – and troubling – for a number of reasons.

First, per the NAIC's data, the majority of US insurer CLO investments were held by large life companies – i.e., those with at least $10 billion in assets under management.[25] Specifically, the top 10 US insurance groups accounted for 45% of the US insurance industry's total CLO exposure, and at least five of the top 10 insurance groups have CLO management subsidiaries.[26] If one or more CLO tranches attract higher RBC charges as a result of the Proposals, this could impact the ability of insurers to continue to operate those subsidiaries which, according to a recent NAIC report, benefit insurer affiliates by providing internal CLO infrastructure and insurer-specific knowledge.[27] Such CLO management subsidiaries may also be more cost-effective for certain insurers and, therefore, of benefit to policyholders. As such, any loss of this internal management function (and the corresponding loss of the ability to provide internal access to an asset class that provides attractive, risk-adjusted returns), would be disadvantageous to insurers and their policyholders.

In addition, as noted above, insurers are among the largest investors in CLO securities. CLOs, in turn, have a significant role in the capital markets generally. However, if RBC charges on CLO tranches were increased as contemplated by the Proposal and, as a result, insurers make fewer CLO investments, the overall volume of CLOs can be expected to decrease significantly, thus taking away an important liquidity tool for the capital markets. The absence of this liquidity tool could have a chilling effect on lenders' willingness to make certain loans (as they would lose a mechanism for achieving liquidity through securitization) and reduce the sources of capital for the large number of corporate borrowers who rely on such loans.

VI. Conclusion

We appreciate the Task Force requesting comments from relevant stakeholders as it engages in the important evaluation of the Proposals. We endeavored to explain why what is contemplated in the Proposals is unwarranted and could have adverse ramifications to policyholders. To that end, we encourage an open and transparent process and to engage an independent consultant with substantial capital markets

[24] *See* PitchBook LCD's Quarterly Leveraged Lending Review: 2Q 2022, p. 98 (Primary Investor Market: Institutional Market by Type – LTM 6/22).

[25] *See* Capital Markets Special Report (NAIC, 2021).

[26] *Id.*

[27] *Id.*

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experience to provide greater technical analysis (including an objective assessment of CLO risk profiles, insurers' investments in CLOs, and the potential impact proposals of this magnitude could have on the insurance industry and US businesses more broadly) prior to advancing, much less adopting, the Proposals. However, we do fully support the necessary requirement for regulators to understand the risks that their regulated entities are appropriately taking and we welcome the opportunity to serve as a resource to the Task Force as it considers the Proposals.

Thank you for the opportunity to comment. AIC looks forward to working with the NAIC on this project.

Sincerely,

Rebekah Goshorn Jurata
General Counsel
American Investment Council

cc: Mr. Charles Therriault
Director, Securities Valuation Office
National Association of Insurance Commissioners (via email)

Ms. Denise Genao-Rosado
Senior Administrative Assistant
National Association of Insurance Commissioners (via email)

July 15, 2022

By Email

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Re: Response to Recommendation Regarding Risk Assessment of Structured Securities – CLOs

Dear Ms. Mears and Mr. Stolte:

Thank you for the opportunity to provide some initial comments on the IAO Issue Paper on the Risk Assessment of Structured Securities – CLOs and the NAIC's proposal regarding collateralized loan obligations (CLOs). We support the structured securities work being performed by the NAIC and agree that considering capital charges associated with CLOs is an important first step. We want to be a resource in this process.

We believe that all asset classes should be evaluated consistently across common stress scenarios. Constituents should strive for transparency and consistency in process and modeling assumptions, and there should be market standard modeling for structured asset classes with appropriate calibration for the risks faced by each asset class.

We also believe that any arbitrage should be addressed. We understand the intuition that there should be no arbitrage available from owning all tranches of a securitization relative to owning an underlying asset where there are no fundamental changes to the risk profile of the underlying asset resulting from the securitization. With respect to CLOs specifically, it may be appropriate to increase the capital charges for CLO equity to reflect additional risk they may bear as shown from modeling and assessment, considering empirical evidence. However, the no-arbitrage principle should reflect the underlying diversification and active management that benefit all tranches of a

CLO structure. In that regard, these structural benefits relative to the underlying assets do not constitute arbitrage.

Benefits of diversification are captured throughout the insurance industry. Insurance is broadly supported by diversification benefits created from pooling different liability risks (*e.g.*, life insurers capture the diversification benefit from pooling mortality risk, and P&C insurers capture the uncorrelated nature of car accidents and hurricanes). Further, asset portfolio theory captures the benefit of holding diverse portfolios of investment grade bonds. These benefits are codified into the capital models used by regulators and rating agencies.

We believe the "no arbitrage" principle should reflect the same benefits of diversification provided to broader portfolios of bonds. The NAIC's new RBC C1o capital charges apply "portfolio adjustment factors," calculated by Moody's, to reflect the benefit of holding more diverse portfolios of bonds (*e.g.*, a portfolio adjustment factor of 0.85 for any bonds after the 100th bond in a portfolio). At a minimum, we believe the aggregate charges for a CLO should reflect applying similar portfolio adjustment factors to the underlying loans.

All existing evidence pre- and post-crisis shows investment grade CLOs have experienced less impairments than equivalently rated corporate bonds.[1] For example, from 2011 to 2020, BBB CLOs have had no impairments vs. 8bps annual average impairments for BBB corporates. If anything, capital charges for investment grade CLOs should be lower than those for equivalently rated corporate bonds to reflect diversification and the other benefits of securitization. CLO tranches benefit from (i) diversification, (ii) active management, (iii) credit enhancement, (iv) structural protections that divert cash flows to investment grade tranches in stress. See the credit impairment of all rated CLO tranches in the table below.

Rating	Corporates	CLO	Other ABS	RMBS	CMBS
Pre-Crisis (2001-2010)					
AAA	0.00%	0.00%	0.00%	0.04%	0.03%
AA	0.05%	0.00%	0.03%	0.29%	0.08%
A	0.11%	0.02%	0.08%	0.76%	0.08%
BBB	0.32%	0.22%	0.63%	1.82%	0.45%
BB	0.85%	0.31%	2.57%	3.17%	1.46%
B	3.00%	1.60%	9.75%	5.09%	3.78%
Post-Crisis (2011-2020)					
AAA	0.00%	0.00%	0.00%	0.02%	0.00%
AA	0.02%	0.00%	0.00%	0.19%	0.05%
A	0.02%	0.00%	0.00%	0.13%	0.05%
BBB	0.08%	0.00%	0.00%	0.36%	0.15%
BB	0.21%	0.13%	0.10%	0.51%	1.58%
B	1.28%	0.66%	0.77%	0.82%	7.15%

[1] See Moody's Investors Service, Impairment and Loss Rates of Global CLOs: 1993-2020 (June 3, 2021) in Excel Supplement Ex. 9 (annual average of 1-year CLO default rates); S&P Annual Global Structured Finance Default and Rating Transition Study (May 2021); Annual Default Study (Feb. 8, 2022) at p. 36 Ex. 37 (annual average of 1-year corporate default rates).

Thank you again. We look forward to engaging with you on these issues.

Sincerely,

Doug Niemann
Executive Vice President & Chief Risk Officer

cc: Charles Therriault, ctherriault@naic.org
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Egan-Jones Ratings Company

Founded 1995

July 15, 2022

Mr. Charles Therriault
Ms. Denise Genao-Rosado
National Association of Insurance Commissioners
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New York, New York 10004

Re: Risk Assessment of Structured Securities – CLOs

We appreciate the opportunity to comment on the referenced proposal to review designations assigned to CLOs. We are probably uniquely qualified to comment on this proposal as an existing credit rating provider because we have no vested interest in the matter; we do not rate CLOs as an NRSRO and therefore have no ratings that are currently relevant for insurance company regulatory capital.

We believe what is missing from the proposal is the core concept that diversification reduces credit risk. The credit quality of a bank or any other entity is not simply the weighted average credit quality of assets held by the bank. Rather the notion is that with a diversified portfolio, the losses on one asset are made up by the yield on other assets. The adage "Don't put all your eggs in one basket" captures this truism. An accurate analysis of the true credit exposure is critical so that insurance companies can avail themselves of attractive investment opportunities while maintaining a sufficient level of capital for possible losses.

To mathematically support the notion that credit risk declines with diversification, we include a simple example. Our analysis indicates that even a relatively small portfolio of assets (i.e., five or more), provides a significant reduction in risk. Regarding the drivers of risk, there are several:

- the number of assets,
- the return of assets compared to the cost of liabilities, and
- the extent to which the assets are correlated.

Our example involves assets with a 3-year cumulative probability of default at 5.8% and the estimated loss at 2.34%. Below is a summary of the results; as can be seen, even with a small portfolio of five assets, the risk is substantially reduced. As the number of assets in the portfolio increases, the loss marginally declines.

Assets in Portfolio	**3 year Estimated Loss**	**Corresponding Rating**
Single	**2.34%**	**BB**
5 Assets (No Correlation)	**0.09%**	**A**
5 Assets (50% Correlation)	**0.25%**	**BBB+**

Our calculations assume a 1-year cumulative probability of default of 2% and loss given default of 50%. Each asset is equally sized in the multiple asset scenario. The debt liability section has 15% subordination. The asset yield is 5% per annum and debt liability yield is 3% per annum. We would be happy to share the calculations with any interested parties.

We believe the diversification benefit of a portfolio needs to be considered as part of the proposal. The diversification benefit is further realized given the managed nature of most CLOs, which allows for sales of loans to minimize the number of defaults. Lastly, historically, some CLO sponsors have provided support if needed to maintain market goodwill/ access.

Again, we thank you for the opportunity to provide input on this matter and are happy to speak with you or other interested parties if desired.

Sincerely,

/s/ Steve Zhang

Steve Zhang
Associate Director, Senior Analyst

July 15, 2022

Ms. Carrie Mears, Chair
Valuation of Securities (E) Task Force
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Issue Paper on Risk Assessment of Structured Securities - CLOs

Dear Ms. Mears:

The LSTA appreciates the opportunity to comment on the IAO Issue Paper on the Risk Assessment of Structured Securities – CLOs (the "Issue Paper") released for comment by the Valuation of Securities (E) Task Force (the "Task Force"), during its June 9, 2022 meeting. On June 17, 2022, the LSTA submitted a letter on the Issue Paper requesting an extension of the comment period to August 26, 2022. Although the comment period was extended to July 15, we are in part providing this letter to reiterate the need for a measured and thoughtful process with respect to the Issue Paper. Given the significant impact these changes will have for the insurance industry and the economy at large, the process must, in our view, allow all affected parties a meaningful opportunity to appropriately analyze and comment on the full scope of the changes recommended by the Issue Paper, as well as to present needed information and analysis concerning CLO structures.

The LSTA is a not-for-profit trade association made up of a broad and diverse membership involved in the origination, syndication, and trading of commercial loans. The 580-plus members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers, and other institutional lenders, as well as law firms, service providers and vendors. Many of the LSTA's members, including insurance companies, would be significantly impacted by the changes recommended in the Issue Paper.

Executive Summary

The Issue Paper recommends that the NAIC consider changing the RBC framework such that capital requirements for purchasing all tranches of a CLOs (and potentially other structured securities) match the capital requirements for directly holding the underlying collateral, based on the assumption that the investment strategy presents the exact same investment risk as holding the entire pool of underlying loan collateral.

As an initial matter, the LSTA urges a deliberate approach to the Task Force's process for considering changes to the RBC framework for CLOs, including an expansion of the Issue Paper to facilitate a more analytically robust study of the performance of CLOs that takes into account the risks and benefits of CLO structures. The LSTA also recommends that the Task Force provide sufficient time for the industry to provide constructive feedback on the proposal, including consideration of the time necessary for the industry to reorient and react to any changes to the RBC framework recommended by the Task Force.

Secondly, this letter provides initial feedback on the Issue Paper's analysis of the credit risks in CLOs and proposed changes to RBC requirements. Supported by historical data, we demonstrate that CLOs do not have the exact same investment risk of a pool of equivalent loans and instead benefit from structural enhancements embedded in CLOs and active management. These features lead to better investment outcomes and result in an investment product that is less risky than a pool of directly-held assets.

CLO Background

The Issue Paper introduces CLOs, accurately observing that a CLO is a "type of structured security backed by a pool of debt, typically corporate loans with low credit ratings…" that are "managed by a collateral manager." The Issue Paper also observes that CLOs have debt tranches of differing seniority as well as an equity tranche and that "there is a priority of payments, called a waterfall, by which senior debt tranches are paid before junior, or mezzanine, debt tranches. Equity tranches typically do not have credit ratings and are paid out after all debt tranches on a periodic basis." The foregoing description of CLOs in the Issue Paper is accurate but not complete. In addition to the basic outline described above every CLO also contains a number of structural enhancements, including performance tests and portfolio quality constraints that, as we discuss in more detail below, provide significant benefits to their investors. CLOs have a long history of demonstrating significantly better credit performance than an equivalent portfolio of directly held corporate loans of equivalent average credit rating, with materially fewer losses due to default.

It is important to note in considering the broad impact of the proposed changes that CLOs provide over $900 billion of capital to the U.S. syndicated institutional leveraged loan market and are the single largest holder of such loans in the US, holding more than 60% of

the $1.4 trillion market that provides financing to thousands of US companies. Thus, CLOs are a vital source of professionally risk-managed and efficiently structured capital to the U.S. economy. Without a functioning CLO market, access to capital would be far more difficult and expensive for U.S. companies.[1] In addition, investments in CLO debt tranches provide insurance companies with superior risk adjusted returns when compared with most alternative investment opportunities. Insurance companies currently hold over $193 billion in CLO assets, comprising 2.6% of insurance company cash and invested assets as of 2020.

Life insurance companies, in particular, rely on the CLO market to invest a portion of their balance sheets in high performing reliable assets with appropriate RBC charges and attractive yield characteristics. For these companies writing long-tail liabilities, CLOs represent an investment solution that helps meet their asset-liability matching goals. Rapidly changing the RBC framework for CLOs based on incomplete assumptions of CLO risks, without due consideration of active management and testing, embedded protections and structural enhancements, will have unintended, material, consequences for insurance companies and their policyholders. Making CLOs more costly from an RBC perspective without thorough and appropriate analysis of the risks and benefits of CLO structures or considering the time needed for the industry to prudently evaluate and adjust their investment portfolios could have a significant, dislocating impact on insurance company balance sheets and the loan market, which may result in more costly insurance products without any attendant benefit being realized in terms of the safety and soundness of the insurance companies selling those products. Without sufficient time for insurance companies to reorient their investment portfolios in response to the changes proposed by the Issue Paper, dramatic increases in RBC charges could lead to forced sales of otherwise performing assets and dislocate the CLO market, potentially impairing insurance company capital and surplus.

Issue Paper Recommendations

The Issue Paper presents the following regulatory issue:

> 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.

[1] According to a study by John Dunham & Associates, the syndicated loan industry generated over 10 million jobs across the country in 2020. Report available at https://www.lsta.org/content/u-s-corporate-loan-market-economic-impact-study/#.

To remedy this perceived regulatory concern, the Issue Paper recommends that:

> (1) the capital required for holding all tranches of a structured security should be consistent with the capital required when holding all the underlying collateral; and
>
> (2) the NAIC consider adding two new RBC factors to account for the "tail risk" in any structured finance tranche of 75% and 100%.

We respectfully disagree that insurance companies' investment in CLO tranches represents "RBC arbitrage". Rather, CLO investment activity is reflective of a structured asset class that, through diversification, active management and risk-mitigating tests, changes the risk profile of the underlying loans. CLO tranches are, accordingly, appropriately allocated a lighter RBC charge than would apply to a pool of individual underlying loans as demonstrated by historically lower default rates, even during times of significant market dislocation. To be clear, the RBC of the individual tranches are not higher than equivalently rated corporate debt and, as we demonstrate below, CLO tranches have consistently outperformed equivalently rated corporate debt. We do not believe the broad regulatory changes proposed in the Issue Paper are supported by the voluminous data available on CLO performance for nearly three decades or in the economic rationale behind the CLO market. The changes proposed in the Issue Paper would greatly benefit from additional study and refinement to appropriately reflect both investment/economic risk and the structural enhancements of CLOs.

Task Force Process

The proposed changes recommended by the Issue Paper are significant and the impact of these changes go beyond addressing perceived "RBC arbitrage". The Issue Paper suggests changes to the treatment of investments in CLOs (and potentially other asset backed securities) that could possibly affect hundreds of billions of dollars of insurance company investments. We believe investments in CLO tranches should be assessed appropriate RBC charges consistent with other, equivalently rated, instruments and not be penalized by imposing RBC charges applied to underlying loan collateral.

Further, the Issue Paper's recommendations to amend the Purposes and Procedures Manual of the NAIC Investment Analysis Office permitting the Structured Securities Group (SSG) to model CLO investments do not address how the proposed modeling approach would be applied or provide details of the methodology to be utilized. In order for the industry to prepare for what would be a material investment portfolio assessment, it must understand the methodology.

Lastly, the Issue Paper recommends significantly larger RBC factors of 75% and 100% for structured finance "tail risk". The Issue Paper has not provided background information on

how the Task Force is evaluating or defining "tail risk", the basis on which they are supporting these large risk charges. The stress scenarios included in the Issue Paper illustrating CLO tail risk are punitive and contain unrealistic assumptions, while actual CLO performance through real-world stress scenarios like the Great Financial Crisis and the COVID pandemic has been superior to the projected results using the NAIC stress scenarios.

Process Summary and Recommendation

In summary, while the LSTA appreciates the NAIC's critical role in ensuring the proper application of the RBC rules to regulated entities, we believe the RBC framework should be appropriately tailored to address the risk of CLOs and other asset backed securities based upon more robust analysis of the actual investments' risk and structural benefits embedded in these instruments. We are concerned that the potentially expedited approach being taken by the Task Force and its limited analysis could result in a misalignment of the RBC charges to the actual investment risk of CLOs and lead to unintended consequences for insurance companies and the insurance buying public more generally.

We therefore recommend that the Task Force expand the two-page Issue Paper so that these issues are documented in detail and provide interested parties with sufficient time to review the Task Force's underlying methodologies and evaluation of CLOs and provide comments on the Task Force's recommendations in a constructive and analytically robust manner. A more measured approach will facilitate transparency, to both industry and regulators, on the nature of CLOs and the RBC methodology that appropriately captures the risks of these investments, and the magnitude with which any change will impact insurers and the availability of suitable investments for insurers.

The remainder of our letter provides initial feedback on the Issue Paper's analysis of the credit risks in CLOs and the proposed changes to the RBC methodology applicable to CLOs. We hope to address these issues with the Task Force in a more fulsome and quantitative manner which we believe will lead to a proposal that accurately reflects the actual risks and benefits of CLOs.

CLO Credit Risk and Historical Performance

1) *The Issue Paper's Argument*

As summarized above, the Issue Paper states that "[a]n 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." We believe this summary statement, and the Issue Paper's underlying analysis, is overly simplified and, as illustrated below, does not consider the mechanical and structural

attributes of CLOs, as well as qualitative and quantitative constraints embedded in CLOs, that lead to better investment outcomes than a static – or even lightly managed – pool of equivalent loans. We first discuss the structural enhancements of a CLO itself that make it a less risky investment than the pool of assets it securitizes and, second, discuss why a CLO portfolio of assets is less risky than a pool of directly-held assets.

2) *Protections Embedded in the CLO Structure*

The actively managed CLO structure offers significant protections for investors. CLOs contain Overcollateralization, Interest Coverage and Interest Diversion tests that provide significant protection to debt tranches and benefit from structural subordination – key features not present in directly held loan portfolios where these credit protections do not exist.

The Overcollateralization test assesses the par value of the underlying loan collateral against the value of the CLO debt tranches. If the CLO fails the Overcollateralization test, the debt tranches of the CLO (from most senior tranche downward) are paid down until the test comes back into compliance. The Interest Coverage tests works similarly – the interest paid by the loan collateral is tested against the interest payable on the CLO debt tranches and the debt repayment follows the same mechanism to reduce the more senior debt tranches until the test is cured. These tests protect the CLO structure by forcing a deleveraging if a breach occurs. The Interest Diversion test requires that interest proceeds be reinvested into purchasing additional loan collateral, thus increasing the value of the collateral relative to the CLO liabilities. These protective attributes further reduce the credit risk of the liabilities relative to the collateral pool.

In addition to the tests enumerated above, CLOs – indeed, securitizations generally – rely on subordination to provide yet another layer of protection to debt tranches. Analysts have modeled many variations of default/recovery scenarios on CLOs to determine the "breakeven" default rate – in other words, the level of defaults required to create a first dollar of impairment at different CLO debt tranches. For example, in its Global Securitized Products Mid-Year Outlook, Morgan Stanley analysts calculated that assuming a 15% constant payment rate, 60% recovery rate, no call and reinvestment of assets at current Weighted Average Spread (WAS) levels, the median BB note across vintages is capable of withstanding 7% defaults per year for the life of the CLO investment, which can be as long as 10 years. Similarly, Citi analysts modeled defaults and principal losses using increasingly severe scenarios. In Citi's "Prolonged 2009 Credit Cycle" model, their cumulative default curve was higher than the NAIC historical + 1 stdev model. Despite having more severe default curves, using more realistic market assumptions – additional CCC curves atop the default curves, 50% recovery rates, market level reinvestment prices (not par in a downturn), and modest repayment rates – Citi determined that CLO BBB principal remained protected in its stress scenarios. In the most severe scenario, 45% of tested CLO BB

tranches could be subject to impairments of, on average, 42%. That said, Moody's experienced actual loss rate in BB CLO tranches in the last decade was much lower at 4.2%.

3) *Benefits of Active Management With Protective Tests*

The structural enhancements described above make a CLO's liabilities less risky than its portfolio of assets. In addition, a CLO's portfolio of assets, itself, may have less risk than an equivalently-rated pool of assets due to additional portfolio protective tests and active management over the collateral itself.

CLOs are actively managed[2] vehicles where the CLO manager selects assets to purchase and sell in an active secondary market; these investment decisions are subject to several built-in tests that measure and control the quality of the CLO's underlying collateral portfolio. The combination of active management <u>and</u> collateral quality tests helps optimize CLO portfolios, which typically outperform passive or lightly managed loan portfolios that are not subject to the same constraints.

CLO managers must meet three interconnected collateral quality tests:

(i) a Weighted Average Rating Factor Test (WARF), which requires the loans to have a certain minimum rating,

(ii) a Weighted Average Spread Test (WAS), which requires the loans to have a certain minimum spread over the base rate applicable to the liabilities and

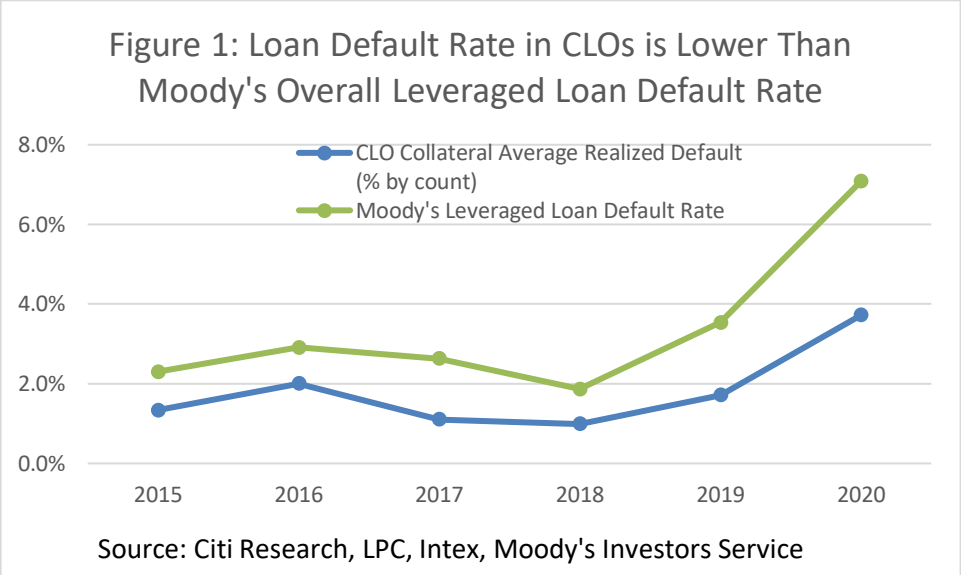
(iii) a Diversity test, which requires the CLO to maintain a certain level of industry and "single-name" issuer diversification.

The combination of these three tests provides guardrails that require the manager to select credit risks that are designed to maintain a stable CLO portfolio.

The outperformance of CLO portfolios vs unmanaged or lightly managed loan portfolios can be observed in Figure 1. Figure 1 illustrates the share of defaulted loans in CLOs compared to the Moody's Leveraged Loan Default Rate. By actively managing their portfolios and selling underperforming loans before they default – usually at prices well above assumed

[2] This comment letter focuses only on actively managed CLOs, and not the small number of static CLOs outstanding.

recovery rates – CLO managers have far fewer defaulted loans in their CLO portfolios compared to the overall loan market.[3]



The collateral quality tests meant to ensure the robustness of the collateral pool, alongside proven active management, neither of which is present for a passive loan portfolio, illustrates that CLO portfolios may not have identical risk profiles as a directly-held loan portfolio and therefore may not warrant identical RBC charges. Therefore, we would encourage the Task Force to re-examine the Issue Paper's assertion that the risk of a CLO portfolio is the same as the risk of a portfolio of loan assets that may not be subject to similar quality tests or able to be as actively managed in non-CLO format.

4) *Historical CLO Performance*

The protective structural enhancements of a CLO, in combination with its active management and battery of investment tests, have led to material outperformance of CLOs since their inception.

CLOs outperformed equivalently rated corporate debt in every rating scale since the inception of the CLO market. S&P reviewed US CLO defaults as of March 2022[4]. Since the

[3] CLO indentures and nationally recognized statistical ratings organization (NRSRO) rating criteria require defaulted assets to be valued at the lower of price or recovery value, strongly incentivizing CLO managers to sell underperforming assets well before a default occurs, encouraging CLO managers to remove defaulting assets from CLO portfolios.

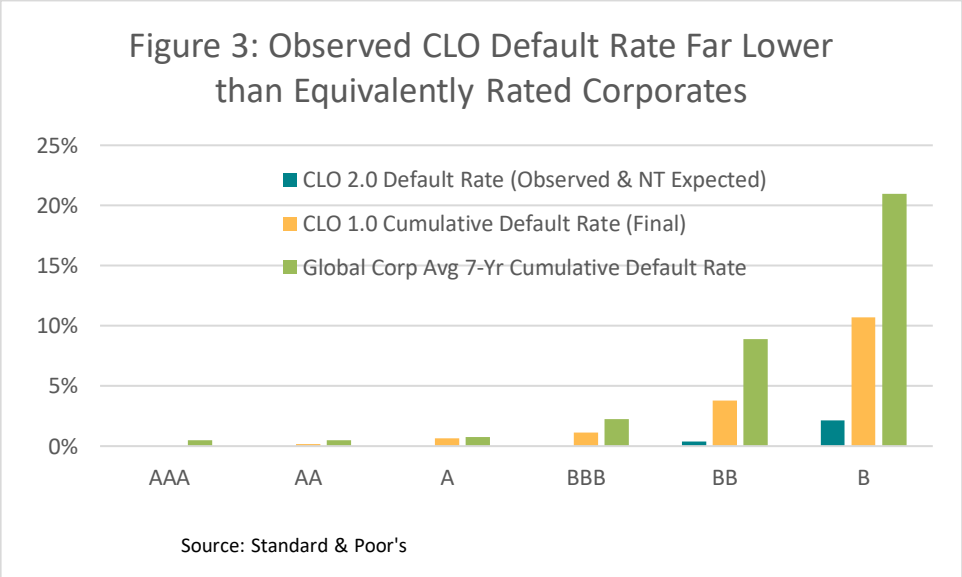
[4] S&P Global Ratings, "CLO Spotlight: U.S. CLO Defaults As Of March 17, 2022.

mid-1990s, S&P has rated more than 16,000 CLO tranches, totaling around $1.2 trillion. The agency divided its data into two components:

(i) so-called "1.0 CLOs", which were issued from the mid-1990s to 2009 and were largely outstanding during the 2008 financial crisis, and

(ii) so-called "2.0 CLOs", which were issued from 2010 onwards and generally have more robust protections, including improved documentation and greater subordination relative to 1.0 CLOs.

Of the 4,322 1.0 CLO tranches rated by S&P, 40 defaulted – or a cumulative default rate of less than 1%.[5] S&P has rated 12,244 2.0 CLO classes, 10 of which had defaulted, or a cumulative default rate of 0.08%, as of March 2022.[6]

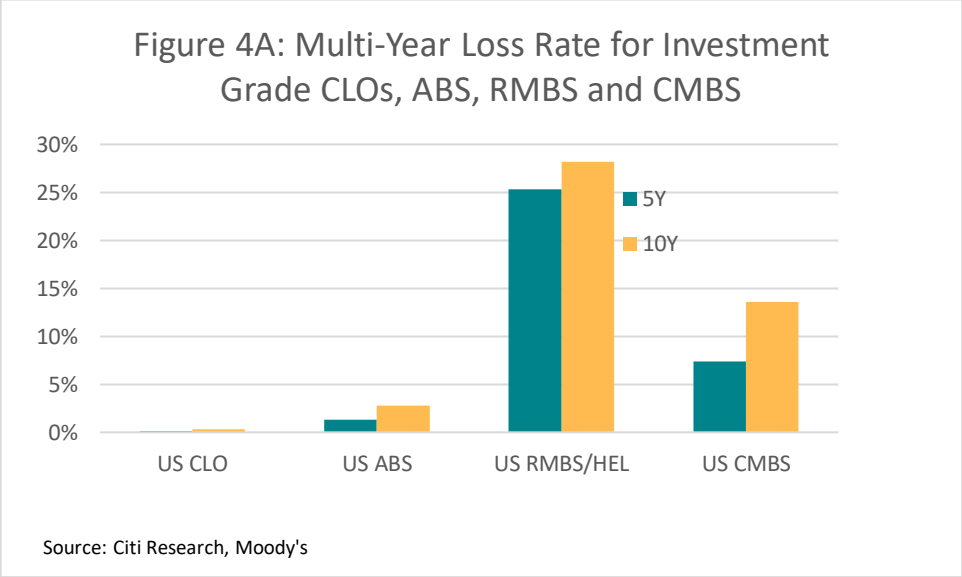


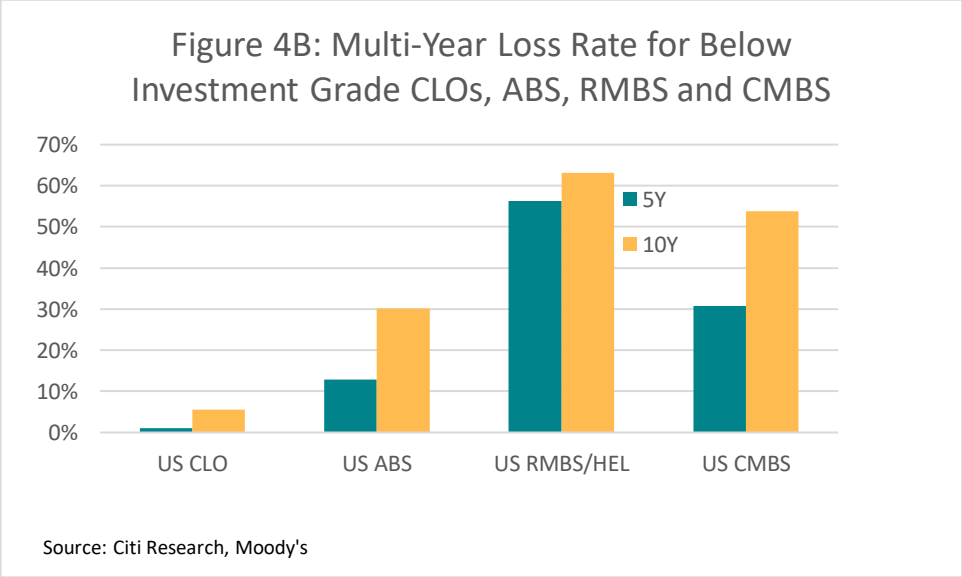
Importantly, as Figure 3 demonstrates, *all* CLO default rates are markedly below that of equivalently rated corporate bonds. At every level of rated CLOs and equivalent corporate bonds, 1.0 CLO default rates – which are final and fixed – are a fraction of corporate bond default rates. In fact, at their ***highest***, CLO tranche default rates are ***half*** that of the equivalently rated corporate bonds. This demonstrates that NRSRO ratings assigned to CLOs are conservative when compared to single-exposure corporate credit ratings and investors are more likely to recover their investment in CLOs than if they invested in equivalently

[5] Because 1.0 CLOs have been fully paid down, the default statistics presented are final.

[6] Because 2.0 CLOs remain an active and a growing asset class, it is possible that 2.0 CLO default rates may increase.

rated corporate debt. In addition, CLOs outperformed other securitized products as well. Figures 4A and 4B illustrate the estimated multi-year cumulative loss rates by original rating from 1993 to 2021. Again, for both the investment grade and the below investment grade tranches, CLO loss rates are a fraction of those of other securitized products.





Ultimately, the active management, structural protections and collateral quality constraints, including CLO tests and subordination embedded in CLOs, combine to create an asset class that has experienced lower losses than either equivalently rated corporate bonds or equivalently rated securitized products. The LSTA respectfully requests the Task Force to consider the protections that make CLO investments distinct from the underlying pool of

corporate loans as well as the historical data on actual CLO performance compared to corporate loans as they consider making appropriate changes to the RBC framework for CLOs.

Conclusion

The Issue Paper raises wide-ranging and complex issues that could potentially impact hundreds of billions of dollars of insurance company investments and require meaningful analysis. The LSTA continues to believe that the current timeframe for comments is not adequate to allow for such analysis.

The LSTA further believes that the arguments presented in the Issue Paper do not fully reflect the economic characteristics of CLOs. The basic premise put forth by the Issue Paper, that CLOs do not in the aggregate outperform the underlying portfolio of loans, is not supported by the observed performance data.

Finally, we wish to emphasize that changing the RBC framework for CLOs without considering the structural benefits of CLOs and their historical performance could potentially lead to unintended consequences for insurance companies, corporate borrowers and ultimately the insurance-buying public. All these complex issues need to be carefully considered and coordinated.

Accordingly, the LSTA respectfully urges the NAIC to revisit the process outlined in the Issue Paper and engage in a dialogue with all relevant constituencies that focuses on the observed economic performance of the CLO market, rather than on an assertion of "RBC arbitrage".

We stand ready to assist NAIC staff, and regulators, to provide clarifying answers to any questions on the content of this letter as well as to provide additional information and analysis concerning CLOs. We appreciate the opportunity to provide comment and engage in future dialogue.

* * *

Thank you for considering the LSTA's comments. If you have any questions, please do not hesitate to contact us.

Sincerely yours,

Meredith Coffey
Meredith Coffey, Executive Vice President

Elliot Ganz
Elliot Ganz, General Counsel

PineBridge® INVESTMENTS

July 15, 2022

Dear Mr. Therriault and Ms. Genao-Rosado:

We would like to thank the NAIC for working on refining the risk assessment of collateralized loan obligations (CLOs) and greatly appreciate the opportunity to comment. We believe the NAIC's CLO proposal understates some key strengths of CLOs. The current risk-based capital (RBC) charges on CLO tranches, both debt and equity, appear already quite conservative based on through-the-cycle performance data, and therefore increasing RBC charges on CLO investments seems unjustified.

Assuming asset RBC equals liability RBC understates several key benefits of the CLO construct.
As part of the proposal, the NAIC assumed the weighted average RBC charges on all CLO tranches equals that of the underlying collateral pool. This assumption may have understated several key benefits of CLOs. We believe that active collateral management, portfolio diversification, and structural protections have all contributed to the strong track record of CLOs. Data shows collateral managers overall were able to reduce credit losses and opportunistically mitigate par losses through portfolio management. CLOs also benefit from the contractual requirement of portfolio diversification, which has contributed to more stable portfolio performance due to limited default correlation among underlying loans. Structural protections such as overcollateralization and interest coverage (OC/IC) triggers have also led to lower impairments for CLO debt compared to corporates and other asset classes.

CLO debt outperformed corporates, supporting lower RBC charges for CLO debt.
The data below – Moody's 10-year cumulative impairment rates by original rating for CLOs issued between 1993-2016 – clearly demonstrates the outperformance of CLO debt for all rating categories relative to corporates and other structured products. This suggests that RBC charges on CLO debt should not be increased and arguably should be lower than those for other asset classes.

	10-year cumulative impairment rate (%)			
Rating	**CLO**	**Corp**	**RMBS**	**CMBS**
Aaa	0.0	0.1	21.1	3.3
Aa	0.0	0.7	53.1	13.7
A	0.1	2.2	70.9	21.3
Baa	2.0	3.5	80.6	24.1
Ba	4.8	15.7	81.2	47.8
B	14.6	35.5	66.1	63.5
Caa		48.9		73.5

Source: Moody's. RMBS: residential mortgage-backed securities. CMBS: commercial mortgage-backed securities.

Over 75% of CLO equities had no principal losses, indicating current equity RBC charges are already conservative for most deals.
Data published by Amherst below indicates that among 797 CLOs issued between 1997-2016, over 75% of redeemed CLO equities (by deal count) have received their initial principal back. The 25th percentile internal rate of return (IRR) was 3%, which means that the equity in these CLOs received more than their initial principal back, resulting in a positive IRR. In addition, the IRR calculation assumed the equity tranche was issued at par, whereas CLO equity is typically issued below par. This would understate the IRR and further support the fact that greater than 75% of CLO equities experienced no principal losses. By original equity balance, this trend was more pronounced. Since not all managers are the same, if useful, we are happy to share PineBridge's CLO performance, very strong overall. Nevertheless, the data below shows the current 20% (property and casualty) and 30% (life) RBC charges on CLO equity are likely too onerous for most CLOs.

	Min	**25P'tile**	**50P'tile**	**75P'tile**	**Max**
IRR	-46%	3%	11%	17%	50%
Orig. Equity Bal. ($million)	3	32	40	53	652

Source: Amherst Pierpont Securities, Portfolio Strategy, 26 July 2021, based on CLOs issued from 1997-2016.

Sincerely yours,
PineBridge Insurance Solutions and Strategies, CLO team, Leveraged Finance team

PineBridge Investments
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STRUCTURED FINANCE ASSOCIATION

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Washington, DC 20006
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July 15, 2022

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

Re: Risk Assessment of Structured Securities (CLOs)

Dear Ms. Mears,

The Structured Finance Association[1] is writing regarding the National Association of Insurance Commissioners ("NAIC") Valuation of Securities (E) Task Force ("VOS TF") exposure of the Investment Analysis Office ("IAO") Issue Paper on the Risk Assessment of Structured Securities – CLOs ("CLO Proposal"). SFA and our members share your commitment in ensuring the strength and resilience of insurance companies for the protection of American consumers. We write to request that the NAIC provide a transparent roadmap for future industry engagement that allows for stakeholder input to be received and considered before the CLO Proposal is finalized. We also request that within this roadmap, the NAIC provide for the publication of a detailed CLO Proposal including the methodologies underlying the model, the stress scenarios and assumptions to be employed and the supporting data used to establish these methodologies and assumptions.

We understand the utmost importance of robust prudential regulatory capital standards and appreciate the goal of ensuring the alignment of capital requirements to the risk profile of the investments. At the same time, an approach that mandates capital requirements disproportionate with the risk of an asset class can artificially curb an otherwise attractive investment opportunity and a critical source of diversification for the U.S. insurance sector. This approach could also unnecessarily cause market disruptions to vital sources of capital market funding to various sectors of the economy including adversely impacting the wide-ranging businesses who rely on the $1.40 trillion CLO market that is the funding source for over 60% of leveraged loans.

[1] The Structured Finance Association is the leading securitization trade association representing over 370 member companies from all sectors of the securitization market. Our core mission is to support a robust and liquid securitization market and help its members and public policymakers grow credit availability and the real economy in a responsible manner. SFA provides an inclusive forum for securitization professionals to collaborate and, as industry leaders, drive necessary changes, advocate for the securitization community, share best practices and innovative ideas, and offers professional development for industry members through conferences and other programs. For more information, visit www.structuredfinance.org.

We appreciate that the NAIC has conducted significant analysis in arriving at the CLO Proposal. We note, however, that market stakeholders have not yet had the opportunity to carefully evaluate the CLO Proposal, including: (i) its assessment of the risk profile of CLO exposure, (ii) its potential impact on the liquidity and valuation of current CLO investments, (iii) the suitable investment opportunities available to insurance companies, (iv) the competitiveness of American insurers, (v) the broader health of our capital markets and (vi) the financing availability and cost to American businesses. Since we do not yet have substantive details on how the risks will be modeled, the data that was utilized to construct the models, or the procedure for how such models will be implemented, SFA and other stakeholders are limited in our ability to provide substantive commentary on the CLO Proposal.

Given these factors, we urge the NAIC to take the following steps:

- First, announce a process by which public input will be sought and considered. The NAIC should make clear that any proposals, methodologies, and models will be adopted, modified, or rejected only after stakeholders are provided the opportunity to comment. Such a process must be transparent and might look to aspects of the Federal notice and comment periods on questions like public notice requirements, comment deadlines, and cost-benefit analyses;
- Second, as part of this process, the NAIC should provide a detailed CLO Proposal that includes materials and data used to support any change in methodologies, models, assumptions, and risk-based capital requirements of the CLO Proposal including:
    - Thorough information on how any change to the assessment will be determined and, if applicable, explaining any permissive "adjustments" allowed, and
    - Detail on any third-party commentary or validation of the model;
- Third, the NAIC should outline how any third-party commentary or validation on the model is incorporated;
- Fourth, the NAIC should publish an ongoing governance process for future changes to any models after the initial CLO proposal has been implemented. This process may include annual updates, approval mechanisms for changes, and a means by which stakeholders can provide updated information in the future; and
- Finally, the NAIC should consider how the CLO Proposal might serve as a precedent for risk-based capital requirements in other structured product asset classes where appropriate, such as the level of stress and the overarching structured finance methodology being considered within structured finance. A consistent regulatory capital approach that accounts for differences in risk for CLOs when compared to other securitized products is vital for the acceptance of not only any change to the treatment of CLOs but also to the treatment of other investments.

A clearly articulated process with ample opportunities for ongoing stakeholder engagement is a critical component of a successful outcome, and we urge the NAIC to view the current CLO Proposal as the beginning of the process, and not the end.

STRUCTURED FINANCE ASSOCIATION

Transparency ensures that structural protections are in place, and that unaccounted for risks and unintended consequences or errors are avoided. In turn, building acceptance across insurance companies and other stakeholders is more likely to be achieved by ensuring vital factors are carefully identified and assessed, which can help policymakers to identify any solutions they may not have initially considered.

Areas of focus in such a transparency assessment include:

- Decades-long historical performance of CLOs,
    - CLOs have had lower impairments than corporate debt in stress scenarios, including 2008 financial crisis and COVID-19;
- Structural improvements in CLOs since 2008
    - CLOs are less complex, with collateral pools limited to corporate loans and bonds
    - Rating agencies and investors demand greater credit enhancement at each ratings level;
- Unique risk attributes of senior and mezzanine CLOs, such as the level of stress under consideration;
- Regulatory capital treatment for CLOs compared to other structured products and compared to corporate debt;
- Resources needed to execute any new responsibilities;
- Short and long-term impact on the insurance companies and the financial markets they support.

Again, we believe that a detailed and well-understood process for future engagement increases market understanding. However, that awareness is contingent upon the NAIC providing the opportunity for stakeholders to share their input, and we urge the NAIC to provide clarity on what such a process might look like. As the NAIC has always welcomed stakeholder involvement consistent with its holistic approach to managing regulatory change, we stand ready to provide further input regarding this important topic and look forward to supporting the NAIC. If you have further questions, please contact Kristi.Leo@StructuredFinance.org.

Best,

Kristi Leo,
SFA President

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July 13, 2022

Carrie Mears
Chair
National Association of Insurance Commissioners
1100 Walnut Street NW, Suite 1500
Kansas City, MO 64106-2197
Submitted Electronically

Re: Issue Paper on Risk Assessment of Structured Securities – CLOs

Dear Ms. Mears:

Teachers Insurance and Annuity Association of America ("TIAA") and its wholly-owned subsidiary Nuveen, LLC ("Nuveen") welcome the opportunity to submit this comment in response to the National Association of Insurance Commissioners ("NAIC") Valuation of Securities (E) Task Force ("VOS TF") exposure draft ("Proposal") of the IAO Issue Paper on the Risk Assessment of Structured Securities – CLOs.[1] The Proposal seeks to substantially modify how insurance companies would calculate risk-based capital ("RBC") charges for collateralized loan obligations ("CLOs") and would meaningfully affect a broad range of stakeholders if adopted in its current form.

We understand that the Proposal seeks to address a potential regulatory arbitrage opportunity resulting from the fact that the aggregate RBC factor for an insurer owning all of a CLO's tranches is less than the required RBC factor where the insurer owns all of the underlying loan collateral. We appreciate the NAIC's concern and wish to participate meaningfully in the discussion surrounding the Proposal. However, we respectfully request an extension of the comment period to provide for a sufficient amount of time for the appropriate stakeholders to review the Proposal and consider its comprehensive impact. An extension is necessary to avoid any unintended consequences for insurers that have invested in CLO securities in the belief that the existing RBC framework accurately addresses the risk of these instruments, as well as the consequences for insurance company-owned CLO managers, given the unique structure and investor base of CLOs. Specifically, we voice our support below for the viewpoints and concerns

[1] *Risk Assessment of Structured Securities – CLOs*, NAIC VOS TF (May 25, 2022), *available at*: https://content.naic.org/sites/default/files/inline-files/2022-004.01%20-%20Risk%20Assessment%20of%20Structured%20Securities%20-%20CLOs%20v3.pdf.

outlined in the comment letters submitted by the Structured Finance Association ("SFA") and Loan Syndications and Trading Association ("LSTA") in response to the Proposal.

I. **About TIAA and Nuveen.**

Founded in 1918, TIAA is the leading provider of retirement services for those in academic, research, medical, and cultural fields. Over its century-long history, TIAA's mission has always been to aid and strengthen the institutions and participants it serves and to provide financial products that meet their needs. To carry out this mission, TIAA has evolved to include a range of financial services, including asset management and retail services. Today, TIAA's investment model and long-term approach serve more than five million retirement-plan participants at more than 15,000 institutions. With its strong nonprofit heritage, TIAA remains committed to our mission of serving the financial needs of those who serve the greater good.

As TIAA's asset management arm, Nuveen offers a wide range of specialized investment solutions through several investment advisory affiliates. The Nuveen organization includes investment advisers that collectively manage over $1 trillion in assets, the large majority of which comes from the TIAA General Account, the TIAA Variable Annuity Separate Account, and mutual fund assets. Nuveen affiliates also manage private equity funds, hedge funds, and structured vehicles.

Nuveen's leveraged finance platform is one of the industry's largest and best resourced providers of high yield credit, broadly syndicated loans, CLOs and alternative credit strategies for broadly syndicated loans. In addition, Nuveen is the parent of Churchill Asset Management, an investment-specialist affiliate of Nuveen that provides customized financing solutions to middle market private equity firms and their portfolio companies. Each of these businesses manages CLOs, and makes investments in CLOs and leveraged loans for TIAA.

While we wish to bring our broad experience in the private funds market, and with CLOs in particular, to bear in responding to the NAIC's Proposal, we believe the current comment period is too short to allow for substantive discussion of the most concerning issues, which are highlighted in the comment letters submitted by the SFA and LSTA.

II. **The NAIC should extend the comment period given the significant concerns raised by the Proposal.**

TIAA believes that an extension of the comment period is necessary in order to properly digest the Proposal, particularly given the extent of the proposed changes and the complexity of the structure of CLOs. As stated in the SFA's comment letter, this Proposal could negatively impact a variety of businesses that rely on the $1.4 trillion-dollar CLO market, which funds over 60% of leveraged loans as the single largest holder of syndicated leveraged loans (as noted by LSTA). We agree with LSTA's assertion that making a substantial change to the RBC charges for CLOs could lead to eliminating CLOs; as a result, U.S. companies could face significant barriers to

capital, including increased costs, and the overall supply of capital for companies could decrease. In addition, we agree with the following issues highlighted in LSTA's comment letter:

- the Proposal fails to identify or define the "uncaptured" risk raised by concerns that the current CRP ratings fail to capture;
- the proposed model does not clearly articulate how it would better capture risk;
- the proposed model has not been validated by a third party; and
- the Proposal fails to quantify the capital impact of the proposal on "affected insurers."

For these reasons, we support LSTA's position that implementing such critical changes without providing stakeholders an adequate comment period to highlight their concerns would be shortsighted. While we appreciate the NAIC's interest in alleviating occurrences of regulatory arbitrage, we believe an extension is needed to provide the industry enough time to examine the Proposal and offer sufficient feedback.

III. **Conclusion.**

We applaud the NAIC's careful attention to this important topic; however, we fully support SFA's and LSTA's request for an extension of the comment period deadline to give interested parties the time they need to engage with the Proposal and comment substantively. By making it easier for the industry to provide meaningful feedback, the NAIC is more likely to achieve its objectives in issuing the Proposal as efficiently and effectively as possible. We welcome further engagement on any of the foregoing.

Sincerely,

John McCally

John McCally

Jennifer Johnson

Jennifer Johnson

ACLI
Financial Security for Life

Mike Monahan
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July 15, 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 ekolchinsky@naic.org

Re: IOA Issue Paper on the Risk Assessment of Structured Securities - CLOs

Dear Ms. Mears:

ACLI appreciates the opportunity to provide comments on the exposed issue paper on risk assessment of structured securities. We would like to reiterate our support for the structured securities work being undertaken by NAIC, as stated in our March 4, 2022 letter (attached to this letter) to the Risk-Based Capital Investment Risk and Evaluation (E) Working Group regarding the Phase II Bond RBC Initiative for Structured Securities.

Overview

ACLI believes the tranches of asset-backed securities (ABS) structures should be evaluated on a consistent methodological basis and that modeling for the tranches of collateralized loan obligations (CLOs) is an important first step to help the NAIC RBC Investment Risk and Evaluation Working Group and NAIC achieve its goals. As part of the guiding principles for this effort, regulators should commit to ensuring the modeling and subsequent capital charge processes are (i) transparent, (ii) consistent across asset classes at the level of stress being examined, (iii) appropriately calibrated for the tail risks faced by each asset class, and (iv) designed to minimize any potential capital arbitrage incentives.

The Proposal in the Issue Paper

ACLI supports the two elements of the exposed proposal. One, we continue to believe that an efficient and effective method for NAIC to align RBC with investment risk for tranches of CLOs is to model all CLO debt and equity tranches, and to subsequently assign NAIC designation categories for each tranche, based on the modeling results to determine RBC.

Second, we are not opposed to new RBC categories to the current lowest level RBC category (30%) for residuals of securitization to allow the NAIC to address potential capital arbitrage; however, more work needs to occur in advancing an actual holistic methodology before deciding on specific factors. In addition, it appears that the NAIC RBC Investment Risk and Evaluation Working Group, after thorough review and modeling, should determine if new factors are warranted. If the RBC designations are to map to the new 20 C-1 bond factors, any new factors should continue to reflect the risk premium that is included in the reserves, so that the provision for default losses cannot exceed the value of the asset.

The review and modeling of the tranches of CLOs should include consideration to retained exposures, diversification with the collateral pool, active management, and other relevant attributes, inclusive of any structural enhancements that improve economic outcomes for investors.

Observations on Proposal for Consideration

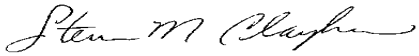
We offer the following observations of the exposed issue paper for consideration:

1. Industry and regulators need transparency in any modeling methodology. We want to understand if the 2020 stress testing model utilized in the issue paper has been previously discussed with industry and regulators. Any modeling should be fully vetted and understood to avoid unintended market confusion and oversimplification of important considerations.
2. ACLI believes that any CLO modeling should consist of at least the following two components: (i) a market-standard structural model[1] that, consistent with CMBS/RMBS modeling (or other third-party model if it is determined that utilizing the CMBS/RMBS model is not a workable approach), takes into account the cashflow waterfall and other unique features of the CLO; and (ii) a range of macroeconomic assumptions that represent stress consistent with the recent modeling of the expansion of the C-1 bond factors from 6 to 20 categories.
3. Any proposal should be consistent among asset classes at the level of stress being considered. The solution for CLOs should be a template for equivalent and transparent treatment across asset classes. We look forward to working with the NAIC to accomplish this.
4. ACLI has the documentation and model that was utilized for the C-1 bond factor work that is available to share with regulators. We believe there should be a thorough analysis of potential models that could be utilized to meet the two components listed above.
5. Finally, we suggest that the Valuation of Securities Task Force and the RBC Investment Risk and Evaluation Working Group invite independent experts to provide open educational sessions on the methodology and process for creating CLOs and any criteria that is followed. The independent experts' methodology should be able to explain the nuances and structural enhancements of CLOs and how a group of sub-investment grade get "tranched" out into various rated/unrated notes.

Overall, we want to ensure that the NAIC and its task forces and working groups follow a sound process, with industry input, and that any modeling and ultimate results are well understood and vetted by all participants, both regulators and interested parties.

Thank you again for the opportunity to comment. The ACLI looks forward to working with the Valuation of Securities Task Force, the RBC Investment Risk and Evaluation Working Group, and other relevant NAIC groups on this very important project.

Sincerely,



Mike Monahan

Steve Clayburn

[1] Two examples of market-standard models are Intex or Moody's models.

ACLI
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March 4, 2022

Philip Barlow, Chair
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Re: Phase II Bond RBC Initiative for Structured Securities

Dear Philip:

ACLI appreciates the opportunity to provide comments on the NAIC's project to review the Risk-based Capital (RBC) treatment of Asset-backed Securities (ABS), including collateralized loan obligations (CLOs), collateralized fund obligations (CFOs), or other similar securities carrying similar types of tail risk. We note that these are preliminary comments on the project, rather than specific comments on any of the technical aspects of the RBC treatment of Asset-backed Securities.

Overview

ACLI agrees with the NAIC that review of the RBC treatment of structured securities is an important follow-up to the work done to develop new RBC factors for bonds. The Phase 1 bond factors were based on the review of default and loss experience of corporate bonds based on their rating, which might not be appropriate for structured securities.

We suggest that, due to the complexity of this project, it would be helpful once an initial path forward (e.g., defining project plan, scope, and writing RFP, if necessary) is decided, or also as part of those discussions, to assemble a representative working group of regulators, NAIC staff, and industry subject matter experts to help address technical elements, with full transparency for all interested parties. It also seems to reason that a significant amount of this technical work would need vetting more broadly at certain stages of development.

Our comments start with a possible outline of a project plan and then we provide our initial responses to the RFC questions.

Suggested Outline of Project Plan

From a timing perspective, ACLI envisions that the project can be covered in two phases. Work on the two phases can be accomplished either sequentially or in parallel, with longer implementation for the second phase as it's more involved with more steps.

1`Phase 1

- Develop a modeling approach or other approach for CLOs and map to current C1 bond factors, potentially leveraging the existing NAIC modeling infrastructure for RMBS and CMBS; review rating agency methodologies.
- Apply a "no arbitrage" principle and evaluate equalization of RBC on the underlying (if available) and the securitization tranches through calibration and by allowing residual tranches to have a variable RBC based on measurable investment risk.
- The implementation plan for Phase 1 could be developed by year-end 2022 and may be less likely to need the assistance of a consultant.

Phase 2

- Assess mapping adequacy and consistency across modeled categories (RMBS, CMBS and CLOs).
- Implement refinements to modeling approaches to ensure appropriate assessment of tail risk.
- Develop a practical approach to map other ABS to current bond factors following the established principles from Phase 1 where the collateral has an assigned RBC. Define alternative approaches, e.g., bottoms-up underwriting, where collateral does not have a well-established RBC.
- Phase 2 is more complex – will likely take 2-3 years. Phase 2 likely requires hiring a consultant that could be engaged from time to time but is not a condition to implement partial solutions.

Project Timeframe

ACLI agrees that this project is a high priority. As noted above, the RBC charges for certain ABS structures, such as CLOs, may be completed relatively expediently, while other structures may take multiple years to complete. While we would expect that the RBC charges would be implemented as they are completed, care should be taken to determine the impact to industry before setting a specific implementation date.

Responses to Specific RFC Questions

Methodologies for capturing the risk (including tail risk) that exists with such assets (e.g., ratings-determined bond factors, a modeling process akin to the current CMBS/RMBS approach, or other proposals).

It is too early to suggest an exact methodology and this needs to be studied further. Structured securities do require a methodology that models collateral outcomes against the capital structure and cashflow waterfall of the security to derive loss projections for each tranche that are representative of the underlying collateral.

Risk modeling approaches for structured securities (beyond RMBS/CMBS) should be evaluated on the basis that they capture the tail risk of a skewed or heavy-tailed loss distribution (e.g., statistical approaches such as Conditional Tail Expectation ("CTE") / TVaR / Expected Shortfall, scenario/stress testing, etc.).

How a consultant or consulting actuary could be used by the NAIC to determine the appropriate charge based upon certain data.

As exemplified during the Phase 1 RBC discussions, a consultant with capital markets expertise can add considerable value. Structured securities are significantly more complex than corporate bonds, reinforcing the need for this expertise. Once the scope of the project has been determined, the consultant could:

- Survey existing regulatory frameworks
- Provide initial modeling and calibration
- If needed, provide ongoing modeling and calibration

Given the technical complexity of structured securities, the ACLI recommends that the consultant coordinate closely with NAIC Structured Securities and Capital Markets Bureau to ensure a robust implementation of the developed recommendations.

The need for review outside of Life RBC (Health, P&C).

Since most insurance investments in structured securities reside in life insurance portfolios, the ACLI supports the initial focus being limited to Life RBC; however, it would be wise for the other two Working Groups to be kept apprised of the work done.

Whether residual tranches in ABS structures can be evaluated in conjunction with and under similar methodologies as the debt tranches.

The full structure, inclusive of all tranches, should be evaluated on a consistent methodological basis. For example, if the NAIC modeled all of the debt tranches of a particular CLO, the cashflow accruing to the residual is simply the difference between the cashflow accruing to the underlying collateral and the cashflow accruing to the sum of the debt tranches.

Specific proposals for addressing RBC treatment of residual tranches to reduce arbitrage incentives.

As a general principle, the level of capital held for all securitized tranches including the residual should generally be consistent with the capital held for the underlying collateral (where specific NAIC capital methodologies are available for such underlying collateral), recognizing retained exposures, diversification within the collateral pool and other relevant attributes, inclusive of any structural enhancements that improve economic outcomes for investors. Modeling of the full waterfall structure would permit the NAIC to perform ongoing checks to ensure that capital arbitrage incentives are minimized.

The ACLI looks forward to working with the NAIC on this project.

Sincerely,

Paul S. Graham, III, FSA, MAAA

cc: Commissioner Scott White, Chair, Financial Condition (E) Committee

Attachment Eleven
Valuation of Securities (E) Task Force
8/11/22

Macroeconomic Scenarios and Assignment of Probabilities for CMBS and RMBS

2022 Summer National Meeting

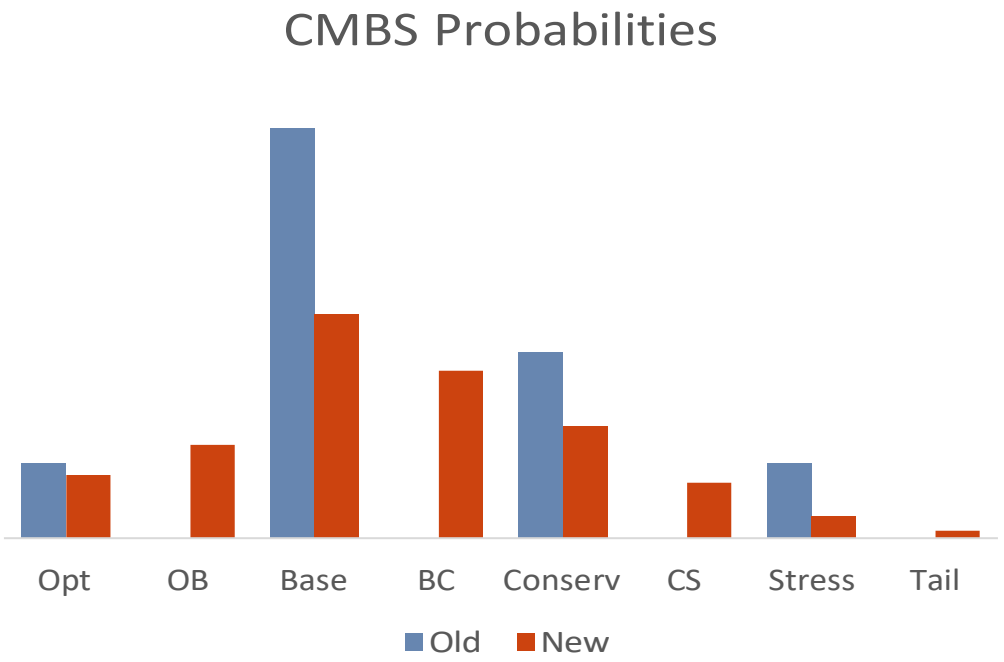
August 11, 2022
Portland, Oregon

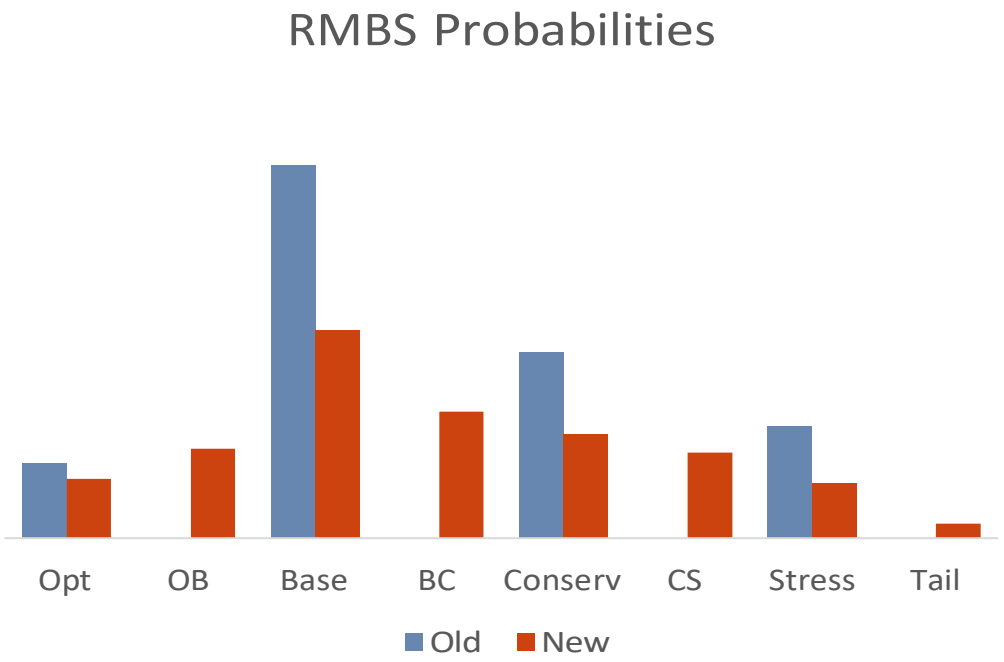
NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Summary

- CMBS and RMBS scenarios were previously presented at the June 9th Valuation of Securities (E) Task Force meeting.
  - We are adding additional macroeconomic scenarios in order to better differentiate among 20 NAIC Designation Categories.
    - Moving from current 4 scenarios to 8 total scenarios for both CMBS and RMBS.
  - These scenarios are meant to be through-the-cycle.
- We have assigned probabilities to each of the CMBS and RMBS scenarios.
  - The probability weights continue to be bell-shaped over the range of the macroeconomic scenarios.
    - Reallocation of probability weights with lower probabilities at the tail and increased aggregate probabilities at the belly.
- We plan to make proforma modeling results available to insurers free of charge later this year, based on each insurer's year-end 2021 holdings.

Assignment of Probabilities





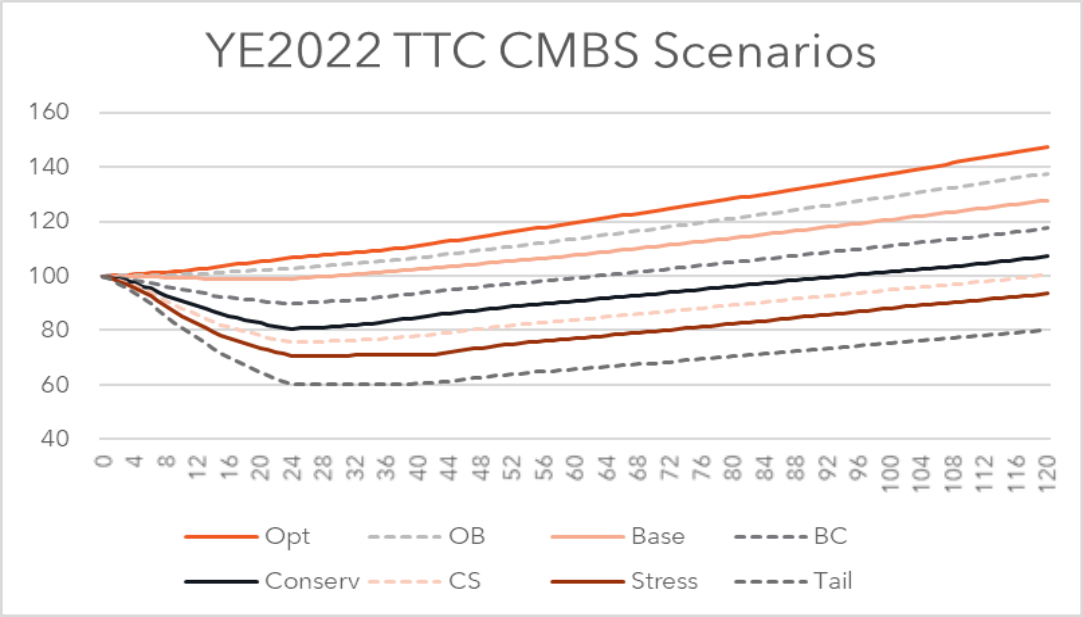
	Opt	OB	Base	BC	Conserv.	CS	Stress	Tail
Old	10.0%	-	55.0%	-	25.0%	-	10.0%	-
New	8.5%	12.5%	30.0%	22.5%	15.0%	7.5%	3.0%	1.0%

	Opt	OB	Base	BC	Conserv.	CS	Stress	Tail
Old	10.0%	-	50.0%	-	25.0%	-	15.0%	-
New	8.0%	12.0%	28.0%	17.0%	14.0%	11.5%	7.5%	2.0%

CMBS Scenarios and Probability Weights

- Total of 8 through-the-cycle (TTC) macroeconomic scenarios including 3 additional scenarios between the current ones and a tail scenario.
- In the table below, the new scenarios (OB, BC, CS and Tail) are in bold.

	Prob.	Current to Trough	Trough Timing (months)	3 Year NPI Growth	5 Year NPI Growth	10 Year NPI Growth
Opt	8.5%	N/A	N/A	10%	20%	47%
OB	**12.5%**	**N/A**	**N/A**	**6%**	**14%**	**38%**
Base	30.0%	-1%	21	1%	8%	28%
BC	**22.5%**	**-10%**	**24**	**-8%**	**-1%**	**18%**
Conserv.	15.0%	-19%	24	-17%	-9%	7%
CS	**7.5%**	**-24%**	**24**	**-23%**	**-16%**	**0%**
Stress	3.0%	-29%	24	-29%	-23%	-7%
Tail	**1.0%**	**-40%**	**24**	**-40%**	**-34%**	**-20%**



RMBS Scenarios and Probability Weights

- Total of 8 through-the-cycle (TTC) macroeconomic scenarios including 3 additional scenarios between the current ones and a tail scenario.
- In the table below, the new scenarios (OB, BC, CS and Tail) are in bold.

	Prob.	3 Year HPI Growth	5 Year HPI Growth	10 Year HPI Growth
Opt	8.0%	18%	28%	47%
OB	**12.0%**	**12%**	**18%**	**27%**
Base	28.0%	8%	10%	12%
BC	**17.0%**	**2%**	**1%**	**-2%**
Conserv.	14.0%	-4%	-7%	-16%
CS	**11.5%**	**-10%**	**-16%**	**-29%**
Stress	7.5%	-20%	-30%	-47%
Tail	**2.0%**	**-31%**	**-44%**	**-62%**