NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Date: 12/12/2021
Virtual Meeting

Valuation of Securities (E) Task Force
Sunday, December 12, 2021
6:00 – 7:30 p.m. ET / 5:00 – 6:30 p.m. CT / 4:00 – 5:00 p.m. MT / 3:00 – 4:30 p.m. PT

ROLL CALL

Dana Popish Severinghaus, Chair	Illinois	Gary Anderson	Massachusetts
Doug Ommen, Vice Chair	Iowa	Chlora Lindley-Myers	Missouri
Lori K. Wing-Heier	Alaska	Eric Dunning	Nebraska
Ricardo Lara	California	Marlene Caride	New Jersey
Andrew N. Mais	Connecticut	Russell Toal	New Mexico
Trinidad Navarro	Delaware	Adrienne A. Harris	New York
David Altmaier	Florida	Cassie Brown	Texas
Dean L. Cameron	Idaho	Jonathan T. Pike	Utah
Vicki Schmidt	Kansas	Scott A. White	Virginia
James J. Donelon	Louisiana	Mike Kreidler	Washington
Kathleen A Birrane	Maryland	Mark Afable	Wisconsin

NAIC Support Staff: Charles A. Therriault, Marc Perlman

AGENDA

1.	Consider Adoption of the meeting minutes for the Summer National meeting, September 30 and November 17, 2021, interim meetings. *(Doc. ID: 2021-037.01, 2021-045.01, 2021-046.01)* —Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)	Attachment One Attachment Two Attachment Three
2.	Discuss and Consider Adoption of a Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Remove Residual Tranches from Receiving an NAIC Designation *(Doc. ID: 2021-043.01, 2021-043.04, 2021-043-05)* —Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)	Attachment Four Attachment Four – A Attachment Four – B
3.	Receive and Consider Adoption of a Proposed Technical Correction Amendment to the P&P Manual Clarifying 5GI Mapping to NAIC Designation Category *(Doc. ID: 2021-044.01, 2021-044.02)* —Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)	Attachment Five Attachment Five - A
4.	Discuss and Consider for Exposure a Proposed Amendment to the P&P Manual an Update the Definition of Other Non-Payment Risk Assigned a Subscript "S" *(Doc. ID: 2021-047.01)* —Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)	Attachment Six

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5. Discuss and Consider for Exposure a Proposed Amendment to the P&P Manual an Update the Definition of Principal Protected Securities (PPS) — Attachment Seven
   (Doc. ID: 2021-048.01)
   —Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)

6. Discuss and Consider for Exposure a Proposed Amendment to the P&P Manual to Assign NAIC Designations to Investments with a Fixed Income Component for Reporting on Schedule BA — Attachment Eight
   (Doc. ID: 2021-049.01)
   —Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)

7. Discuss and Consider for Exposure a Proposed Amendment to the P&P Manual to Permit the SVO to Assign NAIC Designations to Unrated Subsidiaries of in WCFI Transactions — Attachment Nine, Attachment Nine - A
   (Doc. ID: 2021-050.01, 2021-050.02)
   —Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)

8. Hear a Staff Report on Use of NAIC Designations by Other Jurisdictions in the Regulation of Insurers — Attachment Ten
   (Doc. ID: 2021-051.01)
   —Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)

9. Hear a Staff Report on Rating Issues and Proposed Changes to the Filing Exemption Process — Attachment Eleven
   (Doc. ID: 2021-052.01)
   —Kevin Fry (IL), Charles Therriault (NAIC), Marc Perlman (NAIC)

10. Hear a Staff Report on Project of the Statutory Accounting Principles (E) Working Group
    —Kevin Fry (IL), Julie Gann (NAIC)

11. Any other matters

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/00 - Agenda/VOSTF Agenda - 2021.12.12 v2.docx

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Draft Pending Adoption

Draft: 7/28/2021

Valuation of Securities (E) Task Force
Virtual Meeting (*in lieu of meeting at the 2021 Summer National Meeting)*
July 15, 2021

The Valuation of Securities (E) Task Force met July 15, 2021. The following Task Force members participated: Dana Popish Severinghaus, Chair, represented by Kevin Fry (IL); Doug Ommen, Vice Chair, represented by Carrie Mears (IA); Lori K. Wing-Heier represented by Wally Thomas (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kathy Belfi (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Carolyn Morgan (FL); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Chut Tee (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Marlene Caride represented by John Sirovetz (NJ); Linda A. Lacewell represented by Jim Everett (NY); Doug Slape represented by Amy Garcia (TX); Jonathan T. Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays (WA); and Mark Afable represented by Randy Milquet (WI).

1. Adopted its May 24 and Spring National Meeting Minutes

Mr. Fry said the Task Force met May 24 and took the following action: 1) discussed comments received and adopted proposed amendments to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) for the following: a) require the filing of private rating letter rationale reports; and b) permit filing exemption (FE) for credit tenant loan (CTL) and ground lease financing transactions; and 2) received and discussed the Securities Valuation Office (SVO) referral response to the Statutory Accounting Principles (E) Working Group on CTLs.

Mr. Thomas made a motion, seconded by Ms. Clements, to adopt the Task Force's May 24 (Attachment) and March 22 *(see NAIC Proceedings – Spring 2021, Valuation of Securities (E) Task Force)* minutes. The motion passed unanimously.

2. Adopted its 2022 Proposed Charges

Mr. Fry said the Task Force's 2022 proposed charges remain unchanged from 2021.

Ms. Doggett made a motion, seconded by Mr. Kozak, to adopt the Task Force's 2022 proposed charges (Attachment Three). The motion passed unanimously.

3. Adopted a P&P Manual Amendment to Add Additional Instructions to the Review of Funds

Mr. Fry said the next agenda item is to discuss and consider for adoption an amendment to the P&P Manual to add additional instructions to review of funds. The original amendment (Attachment Four-B) was received by the Task Force during the Spring National Meeting and exposed for a 45-day public comment period ending May 6. This updated amendment reflects technical comments and recommendations that were received from interested parties (Attachments Four-C, D and E). The revised amendment was received and approved for exposure through a Task Force e-vote on June 1 and exposed for a 30-day public comment period ending July 1. There was one supportive joint comment letter received on the updated amendment from the American Council of Life Insurers (ACLI), the North American Securities Valuation Association (NASVA), and the Private Placement Investors Association (PPiA).

Marc Perlman (NAIC) said the new proposal would adhere much more closely than the previous one to Rule 18f-4 under the U.S. Securities and Exchange Commission's (SEC) Investment Company Act of 1940 related to the use of derivatives by registered investment companies, including funds, which the SEC adopted in October 2020. Unlike the previous amendment, which had two separate tests for derivatives depending on the NAIC Fund List on which a fund is listed, this amendment would create a single test. Pursuant to the new proposal, a fund's exposure to: 1) derivatives under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payments or otherwise; 2) short sale borrowings; and 3) reverse repurchase agreements or similar financing would be limited to 10% of the fund's net assets in normal market conditions. Exposure would be calculated

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based on the gross notional amounts of derivatives, the value of assets sold short for short sale borrowings, and the proceeds received by the fund but not repaid for reverse repurchase agreements. Consistent with the SEC Rule, interest rate derivatives and option contracts exposure could be calculated with other defined methods consistent with market practice. Also consistent with the rule, certain currency and interest rate derivatives that hedge currency or interest rate risk associated with one or more specific equity or fixed-income investments of the fund would be excluded from the 10% exposure calculation.

One difference between this proposal and the SEC Rule is that the P&P Manual's methodology requires a look-through assessment of all funds which, in turn, includes a requirement that a fund "predominantly hold" bonds or preferred stock, as applicable. As defined in the P&P Manual, "predominantly hold" means that a fund holds at least 80% of its assets in bonds or preferred stock, depending on the type of fund, in normal market conditions. This existing requirement, therefore, limits total derivatives, short sale borrowing, and reverse repurchase agreement exposure in any fund to 20%, exclusive of the excluded currency and interest rate derivatives. The amendment proposes calculating that exposure as previously explained, using gross notional amount for the derivatives. However, for derivatives under which a fund is not or a fund shall not be required to make any future payment or delivery of cash or other assets, exposure would be calculated based on the derivative's market value, a less conservative measure than gross notional, due to diminished risk of loss to the fund. These derivatives would include, for example, certain options pursuant to which the fund would have no possible future payment obligation following the initial premium payment. The Credit Risk Assessment portion of the existing methodology would also be updated to include a calculation of derivative exposure and, if analytically appropriate, the inclusion of derivatives in the weighted average rating factor (WARF) analysis. Derivative documentation can be complex and its review time-consuming. To expedite reviews of funds with derivatives while ensuring that the fund does not breach the proposed exposure thresholds, the proposal includes a new filing requirement to include certain derivatives information in the schedule of portfolio securities and assets, which is provided to the SVO for its review. Such additional information would include: 1) derivative type; 2) whether the derivative will require the fund to make a future payment or delivery of cash or other assets; 3) whether the derivative is an "excluded derivative transaction;" 4) the counterparty credit rating; and 5) the derivative exposure and how it is calculated. The expectation is that a complete and accurate summary of derivatives in the schedule will prevent the need for the SVO to review derivative legal documentation, but the SVO will reserve the right to request it if it deems it necessary.

Based on comments received from interested parties, the SVO removed the initially proposed management assessment from this amendment. Interested parties expressed concern that the management assessment could further weaken market clarity and predictability.

Mr. Fry said this will add a lot of transparency and understanding of the use of derivatives, and it will be a welcome addition to the P&P Manual.

Mike Reis, representing the ACLI, the NASVA, and the PPiA, said this provides clarity. He said industry appreciates the thought that went into the proposal and fully supports the exposure. It serves multiple purposes that are beneficial to everyone. One thing that was highlighted in the comment letter was that for some of the funds that get a designation, the risk-based capital (RBC) does not flow through from that designation, specifically, those funds in *Statement of Statutory Accounting Principles (SSAP) No. 30R—Unaffiliated Common Stock*. There has been talk in the past of potentially getting the RBC to be reflective of the NAIC designation on those funds. That change may have to go to the Capital Adequacy (E) Task Force and industry is certainly supportive of that change. There are certain things happening in the bond project at the Statutory Accounting Principles (E) Working Group, and there may be a population of other securities that would also benefit from some type of look through for RBC treatment as well.

Eric Hovey (Payden & Rygel) said Payden & Rygel had commented on the earlier version and appreciates that the input was taken, supports the new version, and appreciates the continued movement forward in looking at ways to treat bond mutual funds with look through assessment for capital treatment more aligned to the holdings of securities. Also, the SEC rule that is being mentioned here is not in force until August 2022 for the investment industry. There is a little bit of timing mismatch as far as the industry coming to terms exactly with what will be done for that rule versus this proposal being put forth today.

Ms. Mears made a motion, seconded by Mr. Milquet, to adopt the updated proposed amendment to the P&P Manual to add additional instructions to the review of funds. The motion passed unanimously.

4. <u>Adopted an Amendment to the P&P Manual to Permit FE for CTLs and Ground Lease Financing Transactions.</u>

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Mr. Fry said the next item on the agenda is to discuss and consider for adoption an amendment to the P&P Manual to permit FE for CTLs and ground lease financing transactions. This is a change from the existing policy where these transactions had to be filed with the SVO for a legal, structure and credit assessment and only allow the residual asset exposure up to 5% of the original loan amount. This amendment was exposed on May 28 for a 30-day public comment period ending June 28. The Task Force has received two comment letters that were supportive of the amendment.

Charles A. Therriault (NAIC) said the Statutory Accounting Principles (E) Working Group chairs proposed updating the definition of CTL and ground lease financing (GLF) transactions in the P&P Manual to limit them to only those investments that would meet the definition of a mortgage loan under *SSAP No. 37—Mortgage Loans*. Investments that are securities (which are expressly excluded from SSAP No. 37) that fall under the definition of *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities* would no longer meet the definition of a CTL and ground lease financing transactions in the P&P Manual and would, therefore, become eligible for FE, which includes private rating letters. The SVO can still review these transactions and refer to the CTL and GLF methodologies for any unrated security that is CTL-like or ground lease financing-like that requires filing with the SVO, as would any other unrated security. If this amendment is adopted by the Task Force, the SVO will look to see if there are any rated CTL or GLF transactions in the VISION application, remove the SVO assigned NAIC designation from them, and permit them to flow through FE.

Mr. Fry said that originally this was created for transactions that were mortgage loans that wanted to be on Schedule D, and over time, these types of structures made their way into being securities. The policy in the past has been that even if it was a security, it still had to be filed with the SVO and looked at for these characteristics. The Task Force recognizes that there are other securities that do not have to go through this type of criteria. There is also the *SSAP No. 43R—Loan-Backed and Structured Securities* project at the Statutory Accounting Principles (E) Working Group that will complement this in the future if it gets adopted.

John Garrison (Lease-Backed Securities Working Group) said the Lease-Backed Securities Working Group appreciates the consideration and thought that went into this proposal.

Mike Reese (Northwestern Mutual), representing the ACLI, NASVA and PPiA, said this has had a lot of discussion over the past year. Industry is happy that these securities will receive similar treatment to other securities, and this change dovetails with the *SSAP No. 43R—Loan-Backed and Structured Securities* project at the Statutory Accounting Principles (E) Working Group.

Mr. Thomas made a motion, seconded by Mr. Fletcher, to adopt the proposed amendment to the P&P Manual permitting securities similar to CTL and GLF transactions to use NAIC credit rating provider (CRP) ratings through the FE policy. The motion passed unanimously.

5. <u>Adopted Guidance for WCFIs Consistent with the Statutory Accounting Principles (E) Working Group's Adopted of Changes to SSAP No. 105R and Exposed an Amendment Permitting the SVO to Rely Upon the Unrated Subsidiaries of a CRP-Rated Parent Entity for Only WCFIs</u>

Mr. Fry said the next item on the agenda deals with working capital finance investments (WCFIs). This was last exposed on Nov. 18, 2020, during the Fall National Meeting. There are two separate amendments. One amendment deals with the changes that the Statutory Accounting Principles (E) Working Group made to *SSAP No. 105R—Working Capital Finance Investments* and brings the P&P Manual into alignment with those changes. No comments were received on those changes. The second amendment deals with unrated subsidiaries, and it was exposed in November too but there were comments and updates made to that amendment. It is likely that the second amendment will be re-exposed and also referred to the Statutory Accounting Principles (E) Working Group.

Marc Perlman (NAIC) said the first WCFI amendment the SVO is proposing is unchanged since it was exposed in November 2020. It is intended to remove from the P&P Manual inconsistencies that arose when SSAP No. 105R was revised.

Under the second proposed WCFI amendment, when a WCFI obligor is unrated, cannot be designated by the SVO and is not guaranteed by its parent, the Task Force would direct the SVO to rely on the rating or NAIC designation of an obligor's parent based on its implied support. With this second iteration of the policy amendment, the SVO is recommending certain changes.

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First, the initial test for whether the SVO should be able to rely on the parent's rating required that the obligor constitute a "substantial portion of its parent's operations representing at least 25% or greater of the parent entity's assets, revenue and net income." The SVO proposes removing this requirement since it was deemed too restrictive and could prevent, for example, a 5% subsidiary, which manufactures a crucial component for its parent's product, from benefiting from the policy. Additionally, interested parties explained that they did not think it would always be possible to determine the percentage of the parent's operations because it is not always clear from the parent's financial statements, and the subsidiary often lacks financial statements.

Second, the initial proposal allowed the SVO to notch the designation down from that of the parent based on several subjective factors related to the parent/obligor relationship. The notching provisions were removed so that, according to the policy, the SVO will only imply the parent's rating on the obligor without notching. However, under the policy, the SVO expressly retains its right, in its sole analytic discretion, to notch the designation or choose not to assign a designation to a WCFI program for reasons unrelated to the relationship between the obligor and its parent.

Lastly, there is one clerical correction to the amendment. Where it currently references "eligible NAIC CRP rating" throughout, the word "eligible" was removed because an eligible NAIC CRP credit rating specifically refers in the P&P Manual to ratings assigned to securities eligible for Schedule D reporting. Since the rating on a parent could be an issuer rather than an issue rating, it might not meet the definition of "eligible NAIC CRP credit rating."

Mr. Fry said it would be easiest to consider the two amendments separately. The first amendment brings the P&P Manual into alignment with SSAP No. 105R. It has been previously exposed, and Mr. Fry asked if the ACLI, whose comment letter discussed both amendments, would like to specifically address this first amendment,

Mike Monahan (ACLI) said that the ACLI supports amending the language to agree with SSAP No. 105R and moving forward with the first amendment.

Mr. Fry ask Mr. Therriault for the SVO's recommendation. He recommended adoption of the first amendment to align the P&P Manual to the adopted changes with SSAP No. 105R. Mr. Monahan said the ACLI supports that recommendation.

Mr. Fry said that the second amendment deals with the unrated subsidiary piece and asked if there were any comments on it. Mr. Monahan said the ACLI is supportive of what the Task Force has done and will comment on the exposure. He said it is a safe asset class for large insurers.

Mr. Everett asked if industry might be able to address in their comments some questions he had, and that is that SSAP No. 105R now requires an obligor rating, and the parent will not be the obligor. The SVO indicated that a methodology for these kinds of things is lacking and, in light of the Greensill supply chain financing situation, it has become clear that not even generally accepted accounting principles (GAAP) has any standards for supplier finance programs. Standard & Poor's (S&P) just had a seminar and released a research paper on supply chain finance disruptions. Mr. Everett said if possible, if industry could distinguish the situation from Greensill and address the standards issue in their comment letter, it would be appreciated.

Mr. Monahan said they are on top of what happened with Greensill and have been working with the Financial Standards Accounting Board (FASB) on disclosures so that it is more transparent to users of financial statements.

Mr. Thomas made a motion, seconded by Ms. Doggett, to adopt proposed amendments to the P&P Manual to conform the WCFI guidance to reflect the changes adopted by the Statutory Accounting Principles (E) Working Group to SSAP No. 105R. The motion passed unanimously.

The Task Force also directed the SVO to expose the amendment to direct the SVO to rely upon the unrated subsidiaries of a CRP rated parent entity for only WCFI for a 30-day public comment period and refer it to the Statutory Accounting Principles (E) Working Group for comment.

6. Received a Report on Projects Before the Statutory Accounting Principles (E) Working Group

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Julie Gann (NAIC) said the Statutory Accounting Principles (E) Working Group has three meetings scheduled for the near future. The Working Group plans to meet July 29 in regulator-to-regulator session, pursuant to paragraph 6 (consultations with NAIC staff members) of the NAIC Policy Statement on Open Meetings, to hear state insurance regulator reports regarding financial statement information from the 2020 financial filings. The Statutory Accounting Principles (E) Working Group usually does that in conjunction with the national meetings, but since those have been hybrid sessions, there has not been the opportunity to do so. Any state insurance regulator who would like to have information on any disclosure can contact NAIC staff. There are a handful of items planned for presentation with regard to information that the Working Group has gathered from the financial statements. Some examples are the Federal Home Loan Bank (FHLB) disclosure, the SVO-identified exchange-traded funds (ETFs), the new cash pooling, and permitted practices. Ms. Gann said if anyone wants anything specific, let NAIC staff know.

Additionally, the Working Group plans to meet Aug. 10 in regulator-to-regulator session, pursuant to paragraph 6 (consultations with NAIC staff members) of the NAIC Policy Statement on Open Meetings, to discuss comments received on the Schedule - D project and on the *SSAP No. 97—Investments in Subsidiaries, Controlled and Affiliated Entities* exposure. It also plans to meet Aug. 26 to hear comments on proposed items..

Ms. Gann said with the action taken today on CTLs, Interpretation (INT) 2010 will be reviewed. It formally expires Oct. 1, but with the action that occurred today, that interpretation may no longer be needed. She said the Statutory Accounting Principles (E) Working Group will look at that and hopes to have an update for its Aug. 26 meeting.

7. Discussed Other Matters

Mr. Fry said there is an update from Eric Kolchinsky (NAIC) on updating the structured securities reporting for the legacy and non-legacy changes adopted this spring along with planning for the recently adopted updated RBC factors.

Mr. Kolchinsky said there are two broad categories of updates. The first is the announcement of the selection for the financial modelling request for proposal (RFP). It was a long and tough RFP, and the Structured Securities Group (SSG) selected BlackRock Solutions. There were some excellent bidders, and it was an interesting RFP. Mr. Kolchinsky said the SSG looks forward to working with BlackRock Solutions on many of the issues that are going to be discussed next.

Mr. Kolchinsky said the second issue is that the SSG has a number of overlapping changes that are happening with modeled securities: 1) there is BlackRock Solutions, a vendor that has worked with the SSG before; 2) there is the change from breakpoints to designations for non-legacy securities that requires a technical change; 3) there is through-the-cycle modeling; and 4) there are the changes to the RBC factors from Capital Adequacy (E) Task Force. The SSG and the SVO received a letter from the ACLI discussing many of these issues on financially modeled securities that the SSG will look at with the SVO. The SSG staff are in general agreement with the ACLI letter as to how to prioritize the rollout of all these changes and appreciates the letter in general. The letter has not been exposed yet. There are some issues that are short on details that the SSG needs to work out such as implementation of the zero-loss framework. Mr. Kolchinksy said the SSG may come back to the Task Force to discuss these issues, and there may be a need for some minor changes to the P&P Manual. The biggest issues is moving the implementation of both the breakpoints and on the new 20 designation categories using the new RBC factors into 2022. The rationale for moving this into 2022 is that it will give the SSG the opportunity to think through these changes and bring it to Valuation of Securities (E) Task Force for approval instead of rushing it in for year-end 2021, given all these other changes.

Francisco Paez (MetLife) said, there are a number of changes that are happening on the RBC front, not only on the bond side, but also in other parts of the business, and structured securities is part of that equation. It was important to keep that in consideration. There are changes that industry hoped would get done on the modelled security side to address the issues encountered last year. There is also an operational component, and one thing that industry wanted to make sure of is that things are managed in a way that do not lend themselves to any kind of last-minute operational complexities or risks that are not necessary. The letter recommends prioritizing the orderly adoption of these changes and makes suggestions in terms of which changes are most meaningful to industry to achieve some balance.

Mr. Fry asked if when mentioning year-end 2021 and the 20 designations, is this considering only the six designations for this year-end and then going with 20 designations for next year, 2022.

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Eric Kolchinsky said that is correct. He said what would occur is that the reporting would still be as currently defined in the P&P Manual. There is already a provision for reporting the NAIC designation categories. In terms of calculating the breakpoints between the layers, as well as for the designations, that is a process the SSG would like to do on a more interactive basis with the Valuation of Securities (E) Task Force and not do it hastily, considering everything else that needs to be done for this year-end. He said the SSG would also like to run a few more scenarios, given the extra granularity that will be seen now in the 20 versus the six designations. SSG staff are concerned that having just four scenarios will force the results to bunch up in just a few categories, which understates or overstates the risk to the securities. SSG staff would like to take the year of 2022 to discuss these issues with Task Force and report for the current year with the existing designation categories.

Mr. Paez said what was done last year in terms of mapping of securities is a little bit of a road map that could be used again this year. That way, there can be six categories but still mapping on to the new designation categories where they map to the middle of the designation category. The only point that is going to be important for industry is that those bonds that meet the highest quality definition can make it to the 1.A category. There may be a need for enhancements to the scenarios in order to capture all the granularity. Thinking specifically about this year-end and the path that was used last year could be replicable this year. Mr. Paez said all that would be needed to do is figure out a way to address that 1A category, which, in the absence of more detail, the methodology for the zero loss could be that indicator that allows the mapping to the 1.A category. It should capture really what it is supposed to capture because most of those securities are going to be AAA securities.

Eric Kolchinsky said, in general, SSG staff agreed, but they need to work through it and the operational concerns. The new breakpoint file will need 19 columns instead of five. Vendors on the industry side will need to figure out how to take in the new files, and not having to rush is a huge benefit. Mr. Therriault said the SVO will expose the ACLI comment letter on the Task Force web page.

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/01 - Meeting minutes/VOSTF 2021 Summer National Meeting Minutes (FINAL).docx

Draft Pending Adoption

Draft: 10/27/21

Valuation of Securities (E) Task Force
Virtual Meeting
September 30, 2021

The Valuation of Securities (E) Task Force met Sept. 30, 2021. The following Task Force members participated: Dana Popish Severinghaus, Chair, represented by Kevin Fry (IL); Doug Ommen, Vice Chair, represented by Carrie Mears (IA); Lori K. Wing-Heier represented by Wally Thomas (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Carolyn Morgan (FL); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Marlene Caride represented by Nakia Reid and John Sirovetz (NJ); Adrienne A. Harris represented by Jim Everett (NY); Cassie Brown represented by Amy Garcia (TX); Jonathan T. Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); and Mike Kreidler represented by Tim Hays (WA).

1. Adopted its 2022 Proposed Charges

Mr. Fry said the Task Force's 2022 proposed charges are unchanged, but there was a charge inadvertently omitted in the materials for the Summer National Meeting. That omission has been corrected along with the deletion of a reference to the Investment Risk-Based Capital (E) Working Group, which has been disbanded.

Mr. Thomas made a motion, seconded by Ms. Clements, to adopt the Task Force's 2022 proposed charges (Attachment Three). The motion passed unanimously.

2. Exposed a P&P Manual Amendment to Add the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" List

Mr. Fry said the next agenda item is to discuss an amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to add the U.S. International Development Finance Corporation (DFC) to the "U.S. Government Full Faith and Credit – Filing Exempt" list. This list reflects entities that are instrumentalities of the U.S. government, and the debt obligations issued by them must be fully guaranteed or insured as to the timely payment of principal and interest by the full faith and credit of the U.S. government. Satisfying this high standard permits them to be Filing Exempt (FE) and reported as an NAIC Designation Category of 1.A.

Marc Perlman (NAIC) said an industry participant requested that the Securities Valuations Office (SVO) add the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" list in Part One of the P&P Manual.

In October 2018, the Better Utilization of Investments Leading to Development (BUILD) Act was signed into law. The BUILD Act reorganized and merged existing U.S. government development finance and aid programs, the Overseas Private Investment Corporation (OPIC), and the Development Credit Authority (DCA) of the U.S. Agency for International Development (USAID) into a new agency; i.e., the DFC. The purpose of the DFC is to facilitate the participation of private sector capital and skills in the economic development of less developed countries and countries transitioning to market economies, while advancing U.S. foreign policy interests. It is authorized to do so by making loans or guaranties according to terms and conditions specified in the BUILD Act.

Pursuant to the BUILD Act, the support provided by the DFC and existing support provided by the OPIC and USAID shall continue to constitute obligations of the U.S., and the full faith and credit of the U.S. is pledged for the full payment and performance of its obligations. The DFC is authorized to borrow from the U.S. Department of the Treasury (Treasury Department) to fulfill such obligations of the U.S. government.

Based on this express full faith and credit, the SVO recommends adding the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" list in Part One of the P&P Manual. The SVO recommends maintaining the OPIC and USAID on the list even though they have been subsumed by the DFC, because certain obligations of those agencies may still be outstanding.

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For the avoidance of doubt, any security issued by an entity on the "U.S. Government Full Faith and Credit – Filing Exempt" list shall be filed with the SVO if the security is not fully guaranteed by the U.S. government. For certain entities on the list, statute may require parties other than the U.S. government full faith and credit guarantor to bear a risk of loss equal to a specified percentage of the guaranteed support. For example, the BUILD Act requires parties to a project to bear the risk of loss in an amount of at least 20% of the guaranteed support of the DFC. If an insurance company, as investor, is the party bearing that risk of loss, meaning the securities it purchased are not fully guaranteed by the DFC or another entity on the list, it would need to file those securities with the SVO.

The P&P Manual explains that the SVO has no compliance mechanism for these U.S. government obligations and encourages insurers that are uncertain about the FE status of a security to either file it with the SVO or use the Regulatory Treatment Analysis Service (RTAS) – Emerging Investment Vehicle process.

Mr. Fry directed the SVO to expose this P&P Manual amendment for the addition of the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" list for a 30-day public comment period ending Oct. 30.

3. Adopted a P&P Manual Amendment to Add Spanish GAAP to the List of Countries and Associated National Financial Presentation Standards

Mr. Fry said the next agenda item is to discuss and consider for adoption an amendment to the P&P Manual to add Spanish Generally Accepted Accounting Principles (GAAP) to the list of Countries and Associated National Financial Presentation Standards. There is a specific process that must be followed in the P&P Manual to add to the list of accepted National Financial Presentation Standards. Unlike other amendments that the Task Force considers, this process concludes with an assessment and recommendation by the SVO regarding whether the requested national accounting standard leads to an NAIC Designation analogous to those created by the use of a global financial presentation standard such as U.S. GAAP or International Financial Reporting Standards (IFRS).

Charles Therriault (NAIC) said in 2013, the Task Force adopted a procedure, outlined in Part Two, paragraphs 174–181 of the P&P Manual, on how to submit requests to consider other National Financial Presentation Standards and what steps must occur. The process and actions taken are as follows:

- *A national insurance association (but not individual insurers or other persons) may, by written request, ask the SVO to study the feasibility of adding a country and the associated National GAAP or National IFRS.*

  In March 2021, the SVO received a letter from the American Council of Life Insurers (ACLI) requesting the SVO to consider the National GAAP/National IFRS of Spain for addition to the National Financial Presentation Standards.

- *The national insurance association will, as necessary, identify an accounting firm that is an expert in the national accounting system of the country proposed for inclusion on the list of Countries and Associated National Financial Presentation Standards.*

  The requirement of this step has been fulfilled. The ACLI identified Deloitte of Spain as an expert in the national accounting system of Spain.

- *The national insurance association will work with the SVO to create an educational session on those aspects of financial presentation relevant to the SVO for the purposes of its credit risk assessment.*

  This requirement has been fulfilled. On June 22, Joaquin Sánchez-Horneros, Director and member of the IFRS Centre of Excellence at Deloitte Spain, along with Pablo Castillo Lekuona, Senior Manager in the Department of Global Capital Markets and Accounting IFRS, gave a presentation to SVO analysts.

- *The educational session will focus on the material differences between accounting methods for the income statement and balance sheet and shall include such further or additional areas as the SVO shall deem necessary in view of the specific country and national accounting system proposed.*

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The June 22 presentation by Deloitte included detailed differences between Spanish GAAP and IFRS, including a case study demonstrating the financial statement impact on a company over three years, comparing IFRS to Spanish GAAP.

- *At the conclusion of such educational sessions, the SVO shall assess whether the educational session provides a sufficient basis for it to make needed adjustments to the financial information presented under the national accounting standard.*

  Based on the Deloitte presentation, including the reconciliation case study, it appears that most differences between Spanish GAAP and IFRS can be identified with additional disclosure sufficient to allow an analyst to make any necessary adjustments to an analysis.

- *The SVO shall then assess whether the application of the adjustments in one or more transactions confirms that the use of the national accounting standard leads to the creation of NAIC Designations analogous (in the information they convey about credit risk) to those created by using a Global Financial Presentation Standard.*

  The presentation of the Spanish GAAP review by Deloitte was sufficient for the SVO to draw conclusions as to the ability to analyze credits presented under these accounting guidelines.

The SVO recommends that Spanish GAAP be added to the list of Countries and Associated National Financial Presentation Standards in the P&P Manual, with the additional disclosures noted in the amendment. Catherine Cosentino (NAIC) and Rosemarie Kalinowski (NAIC), the SVO analysts that performed the study, will review the principal differences between Spanish GAAP and IFRS, along with the requested mitigants.

Ms. Cosentino said in reviewing Spanish GAAP versus IFRS, the following differences were identified:

- Operating Leases – Spanish GAAP do not bring these leases on to the balance sheet; they are accounted for as operating leases. Operating lease income and expense corresponding to the lessor and lessee are considered to be income and expenses of the year in which they accrue, respectively. The impact is that lessor income is higher and lessee income is lower than that reported for IFRS, and debt is lower than that of IFRS if adjustments are not made.
- Government Grants – Spanish GAAP initially accounts for the grants as equity and subsequently charges it to the income statement as amortization over time, whereas IFRS prohibits recognizing them immediately as equity. The impact is that equity will be inflated for capital grants, and related debt to cap will be lower than it would be if calculated under IFRS.
- Intangible Assets – Spanish GAAP allows research and development costs to be capitalized with a presumption of a useful life limit of five years. IFRS does not allow research costs to be capitalized. It allows development costs to be capitalized under certain requirements, which will be amortized over their useful life. The impact is that assets are higher than under IFRS since research is capitalized and net income will be lower because of the goodwill amortization, and assets and equity will be undervalued relative to IFRS.
- Financial Instrument (valuation) – Spanish GAAP values financial assets at lower acquisition cost and market, while financial liabilities are valued at repayment value. All changes in fair value of financial liabilities are recognized in the income statement. For IFRS, financial assets are valued at fair value, while financial liabilities are valued at amortized cost. All changes in fair value of financial liabilities are recognized in equity. The impact is that asset value will be understated relative to IFRS if fair value and cost are different. Regarding financial liabilities, changes in fair value will affect the income statement under Spanish GAAP, which could affect financial ratio calculations involving net income, as well as the calculation of earnings before interest, taxes, depreciation, and amortization (EBITDA).
- Financial Instrument (available for sale) Impairment/Reorganization – Spanish GAAP allows for fresh-start accounting in certain situations, while IFRS does not recognize fresh-start. The impact is that reported assets may be overstated under Spanish GAAP.
- Joint Ventures – Spanish GAAP allows for proportionate consolidation, but if it is a 50/50 joint venture, then the equity method can be used. For IFRS, only the equity method is used. The impact is that revenue and operating income will be higher than under IFRS if proportionate consolidation is used. This is likely to significantly distort results if a company has large joint venture holdings.

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As just mentioned, there are several important differences between Spanish GAAP and IFRS that will require mitigants. The items referenced will require additional audited disclosures either in the notes to the financial statements or as supplemental disclosure, thereby allowing the SVO to adjust the financial statements so that the use of Spanish GAAP will have no impact on the ultimate NAIC Designation. Some of these disclosures may not be contained in the notes to Spanish GAAP financial statements; therefore, the following items should be submitted, along with the Spanish GAAP statements:

- A complete set of audited financial statements, which includes balance sheet, income statement, and consolidated statement of cash flows for at least one year, three years, if available.
- Disclosure of operating lease commitments in a manner similar to that required by IFRS or US GAAP.
- Disclosure of government grants, including initial amount and year-to-date (YTD) and cumulative amortization.
- Disclosure of gross capitalized research costs and cumulative amortization.
- Disclosure of gross goodwill and cumulative amortization, including goodwill created by fresh-start accounting.
- Disclosure in the change in fair value for financial assets and liabilities.
- Disclosure on joint ventures not using the equity method, including full financial results.

Mr. Fry said the SVO made a recommendation to accept Spanish GAAP statements if these disclosures are provided, which has been done for other countries. Mr. Fry asked if any Task Force members object to considering this for adoption, and there were no objections. Michael M. Monahan (ACLI) said the ACLI has reviewed all the required disclosures and agrees that they are fair and adequate; the ACLI supports adoption at this meeting.

Ms. Mears made a motion, seconded by Mr. Thomas, to adopt the amendment to the P&P Manual to add Spanish GAAP to the list of Countries and Associated National Financial Presentation Standards. The motion passed unanimously.

4. Exposed a Proposed Amendment to the P&P Manual to Add Bank Loans

Mr. Fry said the next item on the agenda is to receive and discuss a P&P Manual amendment to include bank loans in the definition of obligation.

Mr. Perlman said since 2018, the *Accounting Practices and Procedures Manual* (AP&P Manual) has included bank loans issued directly by a reporting entity or acquired through a participation, syndication, or assignment in *Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds*. Pursuant to SSAP No. 26R, bank loans means fixed-income instruments, representing indebtedness of a borrower, made by a financial institution.

To maintain consistency with the bond definition in SSAP No. 26R, the SVO proposes amending the P&P Manual to clarify that the SVO can assess and assign NAIC Designations to bank loans and the relevant filing instructions and methodology for them. The filing instructions and methodology would follow that of other corporate obligations.

Mr. Everett asked if given that a lot of these bank loans are not securities, they are different from bonds, they are treated differently, and they are regulated differently with different trade mechanics, there is a way to get an assessment on how these would be assessed compared to bonds.

Mr. Therriault said the traditional methodology would follow that of a corporate bond. A bank loan credit risk would not be viewed differently than a corporate bond credit risk; it would be the same analysis process. They are securities reported on Schedule D with other bonds.

Mr. Everett said there are differences as to trading and other things like that, and their seniority in bankruptcy is not being considered. Mr. Therriault said the SVO would consider those issues in the analysis of any corporate security; i.e., its relative position in the capital structure, how much debt is involved, and whether there is any collateral involved that will support the security. Those are all things normally considered for any security. Mr. Perlman said the SVO considers this a clarification amendment for consistency with the SSAP and not an addition.

Mr. Everett asked if there would be a distinction between secured and unsecured loans. Mr. Perlman said it would be looked at as with a corporate debt, and it is part of the methodology currently in the P&P Manual. Mr. Therriault said this amendment is adding bank loans as a footnote to the corporate debt methodology. There is not a separate methodology section being introduced; the corporate methodology will be applied to bank loans.

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Mr. Fry ask how this is identified in SSAP No. 26R. Mr. Perlman said it is listed under the bond definition. Bank loans are listed separately in the back of SSAP No. 26R; there is an exhibit with a glossary with definitions, and that is what is being referred to in the amendment. Mr. Fry said it should be made clear that this is a type of security that falls under what the SVO can review and apply this methodology towards. Mr. Therriault said there is a section in the P&P Manual with a header for bank loans, but it did not have any substance. This amendment is to include bank loans in the corporate methodology section as a footnote and remove that header.

Mr. Everett asked if the securities being discussed are for federal antifraud purposes or just for reporting. If they are securities under the Federal Reserve Act, then they are like bonds, and disclosures must be made. But if they are bank loans, then the disclosure and fraud requirements of the securities laws will not apply. Mr. Therriault said the SVO does not make that level of distinction and neither does the SSAP. Mr. Everett said if they are not securities, then they are not within the purview. Mr. Therriault said the amendment is following the definition of SSAP No. 26R. Mr. Everett said disclosures that are made under the possible sanction of federal securities laws are often different from those that are made outside of those laws. If there is a default in a bank loan, the recovery and cure procedures are dependent on whether the loans are secured or unsecured and where they fit within Articles 8 or 9 of the Uniform Commercial Code (UCC). Those are key differences between loans and bonds, and that is where the question is coming from. Mr. Perlman said there are securities that are unsecured. Mr. Everett said not all loans are securities. Mr. Perlman said Article 9 could also apply to a security with a security interest. Mr. Everett said there is a difference in the priorities setting under Article 9. Mr. Therriault said the SVO looks to see whether there is support to ensure that payments are made. But if there is no credit support, there will be no benefit to collateral if it is not intended to provide a means by which to make payments to the investor. The point of the NAIC Designation is the expectation that principal and interest will be paid on a timely basis. It does not go through the default and recovery process that may occur in bankruptcy.

Mr. Everett said there are also differences in the way they bank loans are traded, which affects liquidity. Mr. Therriault said he would expect liquidity concerns to be reflected in the market value. Mr. Everett said in a bond, there is a promise to pay, but in a syndicated loan, there is an investor that is subject to the decision of the syndicator to collect on the loan.

Mr. Fry directed the SVO to expose the amendment to add bank loans to the definition of obligation to the P&P Manual for a 30-day public comment period ending Oct. 30.

5. Exposed a Proposed Amendment to the P&P Manual to Add Zero-Loss Criteria for Legacy-Modeled RMBS and CMBS

Mr. Fry said the next item on the agenda is to receive and discuss a P&P Manual amendment to add back zero-loss criteria for legacy-modeled residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS).

Mr. Therriault said this was initiated from a memo received from the ACLI requesting that the zero-loss rules be applied back to Part Four of the P&P Manual for RMBS and CMBS. The amendment that is being proposed is to add back the zero-loss criteria and map it to an NAIC Designation Category 1.A. for legacy RMBS or CMBS that are financially modeled and experience zero-losses underneath any of the scenarios being run. As the Structured Securities Group (SSG) moves forward next year in 2022, some of the new scenarios will probably need to be updated in the P&P Manual, but this amendment will provide guidance through year-end 2021. There was a desire to move this through quickly so insurers would know as soon as possible that the Task Force has approved this amendment and they can move forward with system changes and other modifications that may be necessary to accommodate the update.

Tracy Lindsey (North American Securities Valuation Association—NASVA) thanked the SVO for acknowledging the impact to insurers and turning this around quickly to get it into the regulatory systems. Vendors will need to release a change, because it is a late adoption, but completely support the change. Mr. Monahan also said the ACLI appreciates the SVO's sensitivity of timing in getting this change implemented, and it would support a short exposure period of 10 or 15 days.

Mr. Fry directed the SVO to expose the amendment to the P&P Manual to add back zero-loss criteria for legacy-modeled RMBS and CMBS for a 15-day public comment period ending Oct. 15 and conduct an e-vote if there are no substantive comments.

6. Heard a Report from the SSG on the Year-End Process

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Eric Kolchinsky (NAIC) reviewed a presentation for the SSG's year-end modeling process. The SSG is running through-the-cycle scenarios for RMBS. For CMBS, the SSG is using the normal approach that was used previously. There was an adjustment to the base case; the base case last year had a huge impact for COVID-19, and it was adjusted to make a much smaller impact for COVID-19 this year. There is still a lot of uncertainty, especially in CMBS, but this time, the uncertainty is sort of broad. Last year, it was known that things were going to get worse. In the current case, it is not clear that anyone has a good idea of what will happen. A lot of stress has been taken out of the base case scenario.

The SSG will be implementing zero-loss for legacy bonds. It will be a "Y/N" column in the appropriate file. The securities that are zero-loss for non-legacy will be assigned an NAIC Designation Category 1.A. The others will follow the mid-NAIC Designation categories for each one. The threshold for zero-loss and break points are to be determined and will be disclosed. There will be a mid-year update based on what is expected for scenarios, up-to-date financials, and on a pro forma basis by the end of October or early November. The SSG and BlackRock have been working very hard on this.

The SSG will likely introduce several through-the-cycle scenarios in 2022, both for RMBS and CMBS. The SSG is targeting between eight and 12 scenarios because 19 thresholds or break points will be needed. If only four scenarios were kept, there would be bonds clustering around one or the other. This is intended to be a lot more sensitive, and there is no intention to change which way things go, better or worse. The SSG would like to create something aligned with what has been done in the prior distributions but just a little bit more sensitive, given that there will be many more thresholds or break points. This will be brought to the Task Force for its approval, along with the 19 thresholds and break points based on the new risk-based capital (RBC) standards that were set out.

Zero-loss will not apply to non-legacy that will be assigned NAIC Designation Category 1.A for the smallest loss possible. The SSG would also consider, depending on demand, a mid-year update file 2022 if there is interest. Resecuritizations of real estate mortgage investment conduit (Re-REMICs), in terms of what is a legacy or non-legacy, the SSG looks through to the underlying and if the underlying is legacy, it is treated as legacy for break point or NAIC Designations. The other question is the format; there will be two files: a file for legacy securities and another for non-legacy securities. The legacy securities file will look very much like the old file. The non-legacy will look like the Automated Valuation Service (AVS+) file. The NASVA and third-party administrators (TPAs) have been working on all of these files.

Francisco Paez (MetLife) said the approach is clear with the legacy securities with the "yes" or "no" indicator for zero-loss mapping to NAIC Designation Category 1.A. He asked whether non-legacy securities, the ones that do not have any loss, are mapped to NAIC Designation Category 1.A also or if the SSG provides the NAIC Designation. Mr. Kolchinsky said that is correct, those securities that meet the threshold for no loss will be assigned an NAIC Designation Category 1.A directly in the file.

At the beginning of the year, removing the zero-loss completely was discussed. There has since been a request from the ACLI to include it again. For legacy securities, this is becoming a smaller group each year. The SSG does not see an issue with adding back the zero-loss concept for legacy securities; however, since the language was taken out of the P&P Manual, it needs the Task Force's approval to add it back, which is the request in the prior agenda item. Once the new categories and the new approach for 2022 for the 19 break points and thresholds are set, there will be additional P&P Manual updates needed for next year.

Mr. Fry asked what the ramifications would be if the Task Force does not support adding zero-loss securities. Mr. Kolchinsky said an analysis of the ramifications has not been conducted. He said he supports adding back the zero-loss case for the legacy securities to maintain the status quo from last year and the prior years.

Mr. Paez said the inclusion of the zero-loss securities this year avoids a more asymmetric treatment of modeled security versus other bonds at the AAA level. Most zero-loss securities in modeled securities that are non-legacy are really going to be AAA, and they represent by and large the biggest component of the capital structure of securitizations. From that perspective, including it gives a symmetric treatment of AAA structured securities or non-structured securities.

7. Discussed Other Matters

Ms. Lindsey asked to quickly discuss the status of private rating letters, providing rationale to the SVO, and what that looks like starting Jan. 1, 2022. This was an adopted change, and industry has been working with rating agencies to ensure that they

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provide that information starting Jan. 1, 2022 and looking at the current private rating letter population to see which ones have rationale that can be provided to the SVO starting Jan. 1, 2022. The NASVA met with the SVO and some folks from Kansas City Managed IT to discuss what that will look like for filers, and it sounds like it will take some time to get VISION and AVS+ updated to accommodate the changes in the filings. Feeds will be a ways out, and manual filings could be a bit of a challenge in the short term. There was a discussion about timing and what implementation looks like or what the expectations are from state insurance regulators if it is mid-year next year versus Jan. 1.

Mr. Therriault said the expectation is that there will be a VISION enhancement next year to permit the filing of the private letter (PL) rating rationale reports. Hopefully that will be done by mid-year, but that is not certain. It will be a transition over time. The NAIC has spent a tremendous amount of energy this past year on making the modifications necessary for the financially modeled securities. Filers can submit those rational reports if there is a manual PL rating filing, to the extent that they are available. They can also be emailed to the analyst, as necessary, and the SVO will start accumulating them. The expectation is that the VISION application, which is the system that houses all our filings from insurers, will have an acknowledgment field somewhere in the system to be able to identify that a ratings rationale report has been received for the current year. This will permit insurance companies to know whether it was received. It will take time to build out this enhancement, and progress updates will be provided to industry and the Task Force, certainly at each of the national meetings.

Mr. Fry asked for clarification that the adopted amendment require ratings rationale reports to be filed by Jan. 1, 2022. Mr. Therriault said that is correct starting Jan. 1, 2022 but they can be submitted any time during the year.

Mr. Fry said the workaround is to manually send them in until such time as the system can handle them, and the SVO will update the Task Force periodically in between.

Mr. Therriault said there will be manual processes until VISION can be updated, and for a physical PL rating, the rationale report can be attached as an additional document when submitted.

Mr. Lindsey asked if it would it be fair to tell the reporting folks to hold off on that PL suffix until closer to the end of the year, because that is one indicator as to whether the rationale has been filed and accepted. Mr. Therriault agreed that would be fair.

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/01 - Meeting minutes/VOSTF 9.30.2021 Meeting Minutes (Chair review and approval).docx

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Draft: 12/1/2021

Valuation of Securities (E) Task Force
Virtual Meeting
November 17, 2021

The Valuation of Securities (E) Task Force met Nov. 17, 2021. The following Task Force members participated: Dana Popish Severinghaus, Chair, represented by Kevin Fry (IL); Doug Ommen, Vice Chair, represented by Carrie Mears (IA); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone (CT); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Eric Dunning represented by Lindsay Crawford (NE); Marlene Caride represented by Nakia Reid (NJ); Adrienne A. Harris represented by Jim Everett (NY); Cassie Brown represented by Amy Garcia (TX); Jonathan T. Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays (WA); and Mark Afable represented by Michael Erdman (WI).

1. Adopted an Amendment to the P&P Manual to Add the DFC to the U.S. Government Full Faith and Credit – Filing Exempt List

Mr. Fry said the first agenda item is to discuss and consider adoption of an amendment to the *Purposes & Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) for the addition of the U.S. International Development Finance Corporation (DFC) to the "U.S. Government Full Faith and Credit – Filing Exempt" list. This list reflects entities that are instrumentalities of the U.S. government, and the debt obligations issued by them must be fully guaranteed or insured as to the timely payment of principal and interest by the full faith and credit of the U.S. government. Satisfying this high standard permits them to be filing exempt (FE) and reported as an NAIC designation category of 1.A.

Marc Perlman (NAIC) said this is an amendment to add the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" list in Part 1 of the P&P Manual. Under the 2018 Better Utilization of Investments Leading to Development Act (BUILD Act), the U.S. Overseas Private Investment Corporation (OPIC) and the Development Credit Authority of the U.S. Agency for International Development (USAID) were reorganized and merged into a new agency called the DFC. The purpose of the DFC is to facilitate the participation of private sector capital and skills in the economic development of less developed countries and countries transitioning to market economies, while advancing U.S. foreign policy interests. It is authorized to do so by making loans or guaranties according to terms and conditions specified in the BUILD Act.

Under the BUILD Act, the support provided by the DFC, and existing support provided by the OPIC and the USAID, shall continue, to constitute obligations of the U.S., and the full faith and credit of the U.S. is pledged for the full payment and performance of its obligations. The DFC is authorized to borrow from the U.S. Department of the Treasury (Treasury Department) to fulfill such obligations of the U.S.

Based on this express full faith and credit, the Securities Valuation Office (SVO) recommends adding the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" list in Part 1 of the P&P Manual and recommends maintaining the OPIC and the USAID on the list even though they have been subsumed by the DFC, because certain obligations of those agencies may still be outstanding.

For the avoidance of doubt, any security issued by an entity on the "U.S. Government Full Faith and Credit – Filing Exempt" list shall be filed with the SVO if the security's principal and interest are not *fully* guaranteed by the U.S. government. For certain entities on the list, statutes may require parties other than the U.S. government full faith and credit guarantor to bear a risk of loss equal to a specified percentage of the guaranteed support. For example, the BUILD Act requires parties to a project to bear the risk of loss in an amount of at least 20 percent of the guaranteed support of the DFC. If an insurance company, as investor, is the party bearing that risk of loss, meaning the securities it purchased are not fully guaranteed by the DFC or another entity on the list, it would need to file those securities with the SVO.

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The P&P Manual explains that the SVO has no compliance mechanism for these U.S. government obligations and encourages insurers that are uncertain about the FE status of a security to either file it with the SVO or use the Regulatory Treatment Analysis Service (RTAS) – Emerging Investment Vehicle process.

Mike Reis (American Council of Life Insurers—ACLI and the North American Securities Valuation Association—NASVA) said the ACLI and NASVA support the proposal.

Ms. Doggett made a motion, seconded by Mr. Guerin, to adopt the amendment to the P&P Manual for the addition of the DFC to the "U.S. Government Full Faith and Credit – Filing Exempt" list. The motion passed unanimously.

2. Adopted an Amendment to the P&P Manual to Add Bank Loans

Mr. Fry said the next agenda item is to discuss and consider adoption of a P&P Manual amendment to include bank loans to the definition of "obligation."

Mr. Perlman said since 2018 the *Accounting Practices and Procedures Manual* (AP&P Manual) has included bank loans issued directly by a reporting entity or acquired through a participation, syndication, or assignment in *Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds*. Pursuant to SSAP No. 26R, "bank loans" mean fixed-income instruments, representing indebtedness of a borrower, made by a financial institution.

To maintain consistency with the bond definition in SSAP No. 26R, the SVO proposes amending the P&P Manual to clarify that the SVO can assess and assign NAIC designations to bank loans and the relevant filing instructions and methodology. The filing instructions and methodology would follow that of other corporate obligations. To be clear, SSAP No. 26R already includes bank loans in the definition of "bond," so this amendment would only align the P&P Manual to the AP&P Manual and would not be changing current statutory guidance.

Mr. Reis said the ACLI and NASVA support the proposal.

Mr. Fletcher made a motion, seconded by Ms. Reid, to adopt the amendment to the P&P Manual to add bank loans. The motion passed unanimously.

3. Exposed a Referral from the Statutory Accounting Principles (E) Working Group and a Proposed Amendment to the P&P Manual to Remove Residuals Tranches From Receiving an NAIC Designation

Mr. Fry said the next agenda item is to receive a referral from the Statutory Accounting Principles (E) Working Group and consider exposure of a proposed amendment to the P&P Manual to remove residual tranches from receiving an NAIC designation. Residual tranches capture securitization tranches and beneficial interests that reflect loss layers without any contractual payment of principal or interest. Instead, residual tranches are paid after contractual payments of principle and interests have been made to other tranches and are based on the remaining available funds.

Charles A. Therriault (NAIC) said the Statutory Accounting Principles (E) Working Group identified inconsistencies in how residual tranches and interests were being reported, with some entities reporting them on Schedule BA: Other Long-Term Invested Assets, and others reporting them on Schedule D-1: Long-Term Bonds with either self-assigned NAIC 5GI or NAIC 6 designations. To prevent further inconsistency and direct appropriate reporting, on Nov. 10, the Working Group adopted an amendment to SSAP No. 43R—Loan-Backed and Structured Securities to clarify that residual tranches and interests shall be reported on Schedule BA. To accommodate the time frame needed for a Blanks (E) Working Group proposal to expand reporting lines on Schedule BA to capture residual tranches and interests, the Working Group's amendment permits residual tranches and interests currently reported on Schedule D-1 to continue to be reported on Schedule D-1 for reporting year 2021 with an ultimate effective date of Dec. 31, 2022.

The SVO recommends that during this window when residual tranches currently reported on Schedule D-1 are permitted to stay on D-1, they should be allowed to do so only with an NAIC 6* designation and not an NAIC 5GI designation. This is consistent with the Working Group's adopted change. The NAIC 5GI designation is not appropriate for residual tranches and

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interests because according to the P&P Manual, an insurance company is permitted to self-assign an NAIC 5GI to an obligation if it meets all of the following criteria:

- Documentation necessary to permit a full credit analysis of the security by the SVO does not exist or an NAIC credit rating provider (CRP) rating for an FE or private letter (PL) security is not available.
- The issuer or obligor is current on all contracted interest and principal payments.
- The insurer has an actual expectation of ultimate payment of all contracted interest and principal.

Assignment of an NAIC 5GI designation for residual investments is an incorrect application of the guidance because: 1) there are no contracted interest and principal payments to certify as current; and 2) the insurer cannot have an actual expectation of receiving all contractual principal and interest of the underlying collateral as these tranches absorb the losses first for the securitization structure. Although cash flows may pass through to the residual holders at periodic intervals under the waterfall, ultimate returns depend on continued performance. Therefore, there can be no actual expectation that future payments will be received.

Along with the proposed P&P Manual language requiring residuals to be reported on Schedule BA, there is a proposed provision stating that for 2021 year-end reporting, residuals will be permitted on Schedule D-1 with an NAIC 6. If adopted, the SVO requests the Task Force's permission to remove that provision from the December 2022 version of the P&P Manual without further authorization as it will be an obsolete instruction.

Next year, the SVO would like to address additional items in the Working Group's referral with the Task Force regarding the meanings of NAIC 5GI and 6, namely:

- Clarifications to ensure that the NAIC 5GI self-assigned designation is permitted only for securities that could be reviewed for an NAIC designation if the documentation to support a credit analysis could be submitted.
- Clarification that self-assigning an NAIC 6* for securities that do not qualify for NAIC 5GI is not a declaration of potential default. Rather, the self-assignment indicates that the security could not be reviewed for a full credit analysis, and the requirements for an NAIC 5GI could not be met.

Mr. Cohen (KKR & Co. Inc.) asked about the definition of the "residual interest." For structured securities that are unrated at the tranche level but the securitization meets safe harbor rules modeling, should insurers expect to receive modeling results for those securities within the securitization? Eric Kolchinsky (NAIC) said there are a number of other limitations on what does and does not get modeled within the modeling process. Safe harbor is one of them, and the ability and model fit is another issue that is considered when modeling securities. Mr. Cohen said for single-asset, single-borrower commercial mortgage-backed securities (CMBS) transactions, where the securitization is backed by a single mortgage, these are ranging anywhere from 40% loan-to-value (LTV) to up to 75% LTV. The ratings designations are based on rating agency framework. In the cases of tranches that might be above a 60% LTV, there are not a lot of ratings on them and they are unrated, but they do receive contractual principal and interest. For these transactions that are not pool transactions, that are straightforward mortgage securitizations, the question is what should we expect to receive for modeling results. And if not, if capital designations can be provided for the rest of the capital structure, and there is a situation where an insurance company owns mezzanine debt that is junior to this tranche, can some type of designation framework be created? Mr. Therriault suggested taking the question offline because it is unrelated to the amendment the Task Force is considering.

Mr. Fry directed the SVO to expose the P&P Manual amendment to clarify proper reporting and designation for residual tranches and interests for a 15-day public comment period ending Dec. 2 so that the Task Force can consider it for adoption at the Fall National Meeting.

3. Exposed a Proposed Technical Correction Amendment to the P&P Manual Clarifying 5GI Mapping to the NAIC Designation Category

Mr. Fry said the next item is to receive and consider exposure of a technical correction amendment to the P&P Manual clarifying 5GI mapping to a designation category in the recently amended PL rating section.

Draft Pending Adoption

Mr. Perlman said that during at the Task Force's May 24 meeting, it adopted an amendment to the P&P Manual requiring the submission of private rating letter rationale reports with certain private rating letters filed with the SVO. In the May amendment, certain language, which is currently in the printed December 2020 version of the P&P Manual and clarifies that an NAIC 5GI designation is the equivalent of an NAIC 5.B designation category, was mistakenly omitted. The SVO proposes a non-substantive technical amendment to the May amendment to reinsert the omitted language.

Mr. Fry directed the SVO to expose this non-substantive technical correction amendment to the P&P Manual to clarify the mapping of NAIC 5GI to a designation category for a 15-day public comment period ending Dec. 2 so that the Task Force can consider it for adoption at the Fall National Meeting.

4. Receive a Report From the SSG on the Year-End Process

Mr. Fry said the next agenda item is to receive a report from the Structured Securities Group (SSG) on the year-end process.

Mr. Kolchinsky said everyone should receive two files, one for legacy with breakpoints and one for non-legacy with designations. The year-end process is on time and should be delivered within normal schedule. The SSG has a lot of work to do next year. There are two main issues to deal with: 1) introduce new scenarios through the cycle. For residential mortgage-backed securities (RMBS), the SSG will draw from the same distribution that was done for the current year, and for CMBS, new scenarios will be introduced; and 2) there will be new mappings to map all 20 NAIC designation categories and 19 break points based on the new risk-based capital (RBC) factors. This will all go through the Task Force next year.
5.

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/01 - Meeting minutes/VOSTF 11.17.21 Meeting Minutes (Final).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: Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the "P&P Manual) to the clarify the exclusion of Residual Tranches and Interests from Schedule D-1 reporting and to provide temporary NAIC Designation instructions

DATE: November 1, 2021

Summary – The Statutory Accounting Principles (E) Working Group (the "Working Group") identified inconsistencies in how residual tranches and interests were being reported with some entities reporting them on Schedule BA – Other Long Term Invested Assets and others reporting them on Schedule D-1: Long-Term Bonds with either self-assigned NAIC 5GI or NAIC 6 Designations. To prevent further inconsistency and direct appropriate reporting, on September 9, 2021, the Working Group exposed an amendment to *SSAP 43R – Loan Backed and Structured Securities* to clarify that residual tranches and interests shall be report on Schedule BA. The Working Group plans to consider adoption of this amendment at their November 10, 2021, meeting.

The amendment creates a December 31, 2022 effective date for all residual tranches and interests to be reported on Schedule BA without an NAIC Designation. To accommodate the timeframe needed for Blanks (E) Working Group proposal 2021-21BWG to expand reporting lines on Schedule BA to capture residual tranches and interests, the Working Group's amendment permits residual tranches and interests currently reported on Schedule D-1 to continue to be reported on Schedule D-1 for reporting year 2021 but only with an NAIC 6* Designation and not an inappropriate NAIC 5GI Designation.

The NAIC 5GI Designation is not appropriate for residual tranches and interests (see definition from *SSAP 43R* below). Pursuant to the "P&P Manual, an insurance company is permitted to self-assign an NAIC 5GI to an obligation if it meets all of the following criteria:

1. Documentation necessary to permit a full credit analysis of the security by the SVO does not exist or an NAIC CRP rating for an FE or PL security is not available.
2. The issuer or obligor is current on all contracted interest and principal payments.
3. The insurer has an actual expectation of ultimate payment of all contracted interest and principal.

Assignment of an NAIC 5GI Designation for residual investments is an incorrect application of the guidance as (a) there are no contracted interest and principal payments to certify as current and (b) the insurer cannot have an actual expectation of receiving all contractual principal and interest of the underlying collateral as these tranches absorb the losses first for the securitization structure. Although cash flows may pass through to the residual holders at periodic intervals pursuant to the waterfall, ultimate returns depend on continued performance so, therefore, there can be no actual expectation that future payments will be received.

The proposed amendment to *SSAP 43R – Loan Backed and Structured Securities* section 26.c., says:

> For residual tranches or interests[FN] captured in scope of this statement, all reporting entities (regardless of AVR) shall report the item on Schedule BA: Other Long-Term Invested Assets at the lower of amortized cost or fair value. Changes in the reported value from the prior period shall be recorded as unrealized gains or losses.
>
> Footnote: Reference to "residual tranches or interests" intends to capture securitization tranches and beneficial interests as well as other structures captured in scope of this statement, that reflect loss layers without any contractual payments, whether principal or interest, or both. Payments to holders of these investments occur after contractual interest and principal payments have been made to other tranches or interests and are based on the remaining available funds. Although payments to holders can occur throughout an investment's duration (and not just at maturity), such instances still reflect the residual amount permitted to be distributed after other holders have received contractual interest and principal payments.

The SVO recommends amendments to the P&P Manual to clarify the reporting requirements for residual tranches and interests in line with *SSAP 43R*, if and as amended.

Proposed Amendment - The text changes to include reporting instructions for residual tranches and interests is shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2021 P&P Manual format. The SVO requests the Task Force's permission to remove the paragraph with the "NOTE REGARDING RESIDUAL TRANCHES OR INTERESTS" from the December 31, 2022 version of the P&P Manual, without further authorization from the Task Force, as it will become obsolete at that time.

PART TWO

OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTIONS

27. An insurance company that self-assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.

28. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met.

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

30. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.

31. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.

32. Securities that are residual tranches or interests, as defined in *SSAP 43R – Loan Backed and Structured Securities*, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.

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

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

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

…

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:

   …

   - **Residual tranches or interests -** As defined in *SSAP 43R – Loan Backed and Structured Securities*, residual tranches or interests shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are therefore not eligible for filing exemption.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/02 - Remove Residual Tranches/2021-043.01 Task Force 2021 Amend PP To Remove Residuals v3.docx

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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

FROM: Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group
Carrie Mears, Vice-Chair of the Statutory Accounting Principles (E) Working Group

RE: Provisions for NAIC 5GI Designations

DATE: November 15, 2021

The purpose of this referral is to request that the Valuation of Securities (E) Task Force review the NAIC 5GI guidance detailed in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* and consider whether modifications are necessary to clarify the intent of the guidance and mitigate misapplications. As an example, the Working Group was made aware of situations in which residual tranches, which do not have contractual interest or principal payments, were being designated as NAIC 5GI by reporting entities. Although there was broad agreement by key industry representatives and state insurance regulators that the NAIC 5GI should not be permitted for these residual tranches, potential refinement to clarify the NAIC 5GI provisions may prevent future misapplication.

> Residual Tranches Defined per *SSAP No. 43R–Loan-Backed and Structured Securities*: Reference to "residual tranches or interests" intends to capture securitization tranches and beneficial interests as well as other structures captured in scope of this statement, that reflect loss layers without any contractual payments, whether principal or interest, or both. Payments to holders of these investments occur after contractual interest and principal payments have been made to other tranches or interests and are based on the remaining available funds. Although payments to holders can occur throughout an investment's duration (and not just at maturity), such instances still reflect the residual amount permitted to be distributed after other holders have received contractual interest and principal payments.

In addition to clarifying that the guidance cannot be applied to residual tranches, as defined in SSAP No. 43R, the following concepts are provided as suggestions for possible clarification:

- Clarifications to ensure that the NAIC 5GI self-assigned designation is permitted only for securities that could be reviewed for an NAIC designation if the documentation to support a credit analysis could be submitted. In other words, the 5GI process is not intended to be used for securities that would not qualify for a designation even if a full credit analysis could be performed. Securities that cannot be reviewed for an NAIC designation due to the lack of a process / methodology for the type of security or structure are not permitted to be self-assigned an NAIC 5GI designation.
- Clarification that self-assigning an NAIC 6* for securities that do not qualify for NAIC 5GI is not a declaration of potential default. Rather, the self-assignment indicates that the security

could not be reviewed for a full credit analysis and the requirements for an NAIC 5GI could not be met.

Thank you for considering these potential clarifications. Please contact Dale Bruggeman, or Carrie Mears, SAPWG Chair and Vice Chair, with any questions.

Cc: Julie Gann, Robin Marcotte, Jim Pinegar, Jake Stultz, Charles Therriault, Marc Pearlman

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/02 - Remove Residual Tranches/2021-043.04 SAPWG to VOSTF - 5GI.docx

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

November 24, 2021

Mr. Kevin Fry, Chairman
Valuation of Securities Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Exposure Draft to Clarify the Exclusion of Residual Tranches and Interests from Schedule D-1 Reporting and to Provide Temporary NAIC Designation Instructions

Dear Mr. Fry:

The American Council of Life Insurers (ACLI) and the North American Securities Valuation Association (NASVA) ("the undersigned") appreciate the opportunity to comment on the memo exposed after the November 19th, 2021, Valuation of Securities Task Force meeting to "Clarify the Exclusion of Residual Tranches and Interests from Schedule D-1 Reporting and to Provide Temporary NAIC Designation Instructions."

The undersigned fully support the proposed criteria addition. We truly appreciate the constructive dialogue with you, and the Securities Valuation Office.

We thank you for your continued engagement on the topic.

Sincerely,

Tracey Lindsey

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey
NASVA

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 95 percent of industry assets in the United States.

acli.com

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

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

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

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

RE: Non-substantive technical amendment to the P&P Manual for Private Letter Rating Securities and the corresponding NAIC Designation Category for NAIC 5GI

DATE: November 1, 2021

Summary – At the May 24, 2021 Task Force meeting the Task Force adopted an amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) requiring the submission of Private Rating Letter Rationale Reports with certain Private Rating Letters filed with the SVO. In the May amendment certain language, currently in the printed December 2020 version of the P&P, which clarifies that an NAIC 5GI Designation is the equivalent of an NAIC 5.B Designation Category, was erroneously omitted. The SVO proposes a non-substantive technical amendment to the May amendment by re-inserting the omitted language as shown below in red (additions underlined and deletions with ~~strikethrough~~), as well as including identical language in one paragraph adopted pursuant to the May 2021 amendment.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

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

…

PL SECURITIES

. . .

12. For (a) PL Securities issued from January 1, 2018 to December 31, 2021 subject to a confidentiality agreement executed prior to January 1, 2022, which confidentiality agreement remains in force, for which an insurance company cannot provide a copy of a private rating letter rationale report to the SVO due to confidentiality or other contractual reasons ("waived submission PLR securities"), the insurer may report such securities on such securities' General Interrogatory (i.e., a **PLGI** security), and (b) PL Securities issued after January 1, 2022, for which an insurance company cannot provide a copy of a private rating letter rationale report to the SVO due to confidentiality or other contractual reasons ("deferred submission PLR securities") the insurer may report such securities on such securities' General Interrogatory (i.e., a **PLGI** security) until and including December 31, 2023, after which time, if the insurance company still cannot provide a copy of a private rating letter rationale report for whatever reason, the securities can be reported with an NAIC 5GI Designation and an NAIC Designation Category of **NAIC 5.B GI** in accordance with the guidance specified below.

. . .

Conditions to Filing Exemption for PL Securities Issued on or After January 1, 2018

. . .

16. An insurer that owns a **PL** security that is not filing exempt shall either: (a) file the security with the necessary documentation with the SVO for an analytically determined NAIC Designation; or (b) self-assign an **NAIC 5GI** and an NAIC Designation Category of **NAIC 5.B GI** to the security and report using the Interrogatory procedure; in either case within 120 days of purchase.

Producing NAIC Designations for PL Securities

. . .

22. If the SVO verifies that the security:

    - Has been assigned a credit rating but that the credit rating is not an Eligible NAIC CRP Credit Rating; or
    - Has not been rated by an NAIC CRP; or

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- Is no longer subject to a private letter rating; or
- Is a type of security that is ineligible to receive an NAIC Designation with a NAIC CRP Credit Rating.

The SVO shall notify the insurer that the security is not eligible for filing exemption. The insurance company shall then either file that security and necessary documentation with the SVO for an independent credit assessment or assign an **NAIC 5GI** ~~Regulatory~~ Designation and an NAIC Designation Category of **NAIC 5.B GI** to the security in the related Interrogatory.

If the SVO deems a security ineligible to receive an NAIC Designation per the instructions in this Manual because (a) the security is ineligible for Filing Exception according to "Specific Populations of Securities Not Eligible for Filing Exemption" in this Part or (b) the security is of a type outside the scope of *SSAP No. 26R - Bonds, SSAP No. 32- Preferred Stock, or SSAP No. 43R – Loan Backed and Structured Securities* then, for such a security, the SVO will provide a brief explanation in VISION, accessible to all VISION account holders, of why the security will not be provided an NAIC Designation.

23. An **NAIC 5GI** Designation and an NAIC Designation Category of **NAIC 5.B GI** may also be used in connection with the designation of **PL** securities rated by an NAIC CRP (i.e., for private letter ratings issued on or after January 1, 2018) when the documentation is not available for the SVO to assign an NAIC Designation. For purposes of this section, the documentation is not available for the SVO to assign an NAIC Designation if (a) the NAIC CRP credit rating is not included in the applicable CRP credit rating feed (or other form of direct delivery from the NAIC CRP) and the insurer is unable to provide a copy of the private letter rating documentation, (b) for private letter ratings issued on or after January 1, 2022, an insurance company does not provide a copy of a private rating letter rationale report to the SVO for which there are no confidentiality or contractual limitations or (c) for deferred submission PLR securities, if the insurance company does not submit the private rating letter rationale report to the SVO on or after January 1, 2024.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/03 - 5GI Non Substantive Technical Correction/2021-044.01 PP Manual Amend - NonSubstantiveTechCorrectionsPLR_5GI v3.docx

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Michael Monahan
Senior Director, Accounting Policy
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November 24, 2021

Mr. Kevin Fry, Chairman
Valuation of Securities Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Exposure Draft for Private Letter Rating Securities and the Corresponding NAIC Designation Category for NAIC 5G

Dear Mr. Fry:

The American Council of Life Insurers (ACLI) and the North American Securities Valuation Association (NASVA) ("the undersigned") appreciate the opportunity to comment on the memo exposed after the November 19th, 2021, Valuation of Securities Task Force meeting for "Private Letter Rating Securities and the Corresponding NAIC Designation Category for NAIC 5G."

The undersigned fully support the proposed criteria addition. We truly appreciate the constructive dialogue with you, and the Securities Valuation Office.

We thank you for your continued engagement on the topic.

Sincerely,

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey
NASVA

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 95 percent of industry assets in the United States.

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

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.

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: Purposes and Procedures Manual amendment to add guidance on the designation of Schedule BA assets with fixed income characteristics

DATE: November 17, 2021

Summary – The SVO recommends updating the instructions in Part Three of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (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. Including the proposed provisions would enable the SVO to assign NAIC Designations to Schedule BA assets which are not expressly covered by other sections of the P&P Manual (e.g. Schedule BA Non-Registered Private Funds with Underlying Assets Having Characteristics of Bonds or Preferred Stock). Schedule BA assets for life and fraternal insurers 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 that, "The SVO is assigned to assess investment securities reported to state regulators on Schedule D and Schedule BA." (Paragraph 40). Additionally, the P&P explains 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.

> Insurers may file a Schedule BA asset with the SVO if they can represent that the asset has underlying characteristic of a bond or other fixed income instrument. When an insurer files a Schedule BA asset the SVO assesses the insurer's fixed income determination and it if agrees that the asset has fixed income characteristics, conducts a credit assessment and a valuation of the asset. Upon conclusion of its analysis, the SVO provides the insurer a response setting forth its determination as to the NAIC Designation and asset classification assigned to the asset. Upon receipt of the SVO response, the insurer reports the aforementioned analytical values obtained from the SVO for the asset on the NAIC Financial Statement Blank. (P&P Manual, Part One, Paragraph 99)

This proposed amendment would potentially make various types of assets eligible for an NAIC Designation which currently are not. Each asset would need to be individually assessed by the SVO for bond or fixed income characteristics.

Proposed Amendment - The text changes to add guidance to the P&P on the designation of Schedule BA assets with fixed income characteristics 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

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:

   …

   - **Schedule BA Assets** – Assets eligible for reporting on Schedule BA, and not otherwise subject to the processes or procedures of another section of this Manual, are ineligible for the filing exemption procedure.

SCHEDULE BA ASSETS

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

Definition

320. Pursuant to this section, Schedule BA Assets include any asset eligible for Schedule BA which is not otherwise subject to the processes or procedures of another section of this Manual, and which has underlying characteristics of a bond or other fixed income instrument.

Required Documentation

321. In accordance with Part One of this Manual, when filing a Schedule BA Asset with the SVO, an insurer must submit a representation that the asset has underlying characteristics of a bond or other fixed income instruments. Additionally, the insurer shall submit any other information or documentation which the SVO deems necessary for it to make a determination about the asset's underlying characteristics and, if thereafter necessary, to perform a credit assessment. An insurer determination that an instrument has fixed income characteristics also suggests it ought to have documentation very similar in nature to what would be presented to the SVO for a Schedule D asset; for example, an Audited Financial Statement, loan documentation or legal agreement.

Legal Review

322. The SVO shall review legal agreement(s) related to the transaction (e.g. prospectus, indenture, loan agreement, note purchase agreement, partnership agreement, guarantee or equivalent legal documents) along with any amendments, waivers, compliance certifications and opinions of counsel it deems necessary for its analysis.

Analysis and Methodology

323. The SVO will first assess the insurer's fixed income determination. Only if the SVO agrees that the asset has fixed income characteristics and determines that it has the appropriate methodology and sufficient resources with which to conduct its analysis, will the SVO then conduct a credit assessment of the asset for the assignment of an NAIC Designation Category.

Maintenance and Monitoring

323. Maintenance and monitoring of SVO determinations for Schedule BA Assets will be conducting in accordance with "Maintenance and Monitoring of SVO Determinations For Schedule BA Assets" in Part One of this Manual.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/06 - Sch BA Fixed Income Component/2021-049.01 Task Force 2021 Amend PP SchBA Fixed Income Comp v2.docx

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: Purposes and Procedures Manual amendment to permit un-guaranteed and unrated subsidiary obligors in WCFI transaction, with SVO discretion

DATE: November 24, 2021

Summary – The SVO has 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 Credit Rating Provider (CRP) rated parent.

In November 2020, the Task Force exposed a proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the "P&P Manual") to direct the SVO to rely upon the NAIC Designation or NAIC CRP Rating equivalent of the subsidiary obligor's parent entity, with allowance for the SVO to notch down from the parent's rating or NAIC Designation due to its assessment of certain factors regarding the parent/subsidiary relationship. In response to feedback from some Task Force members and interested parties, the SVO subsequently presented a revised proposal to the Task Force at the Summer 2021 National Meeting to remove its discretion to notch because, as demonstrated in its memorandum to the Task Force of October 16, 2020, 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. This revised amendment was also not adopted by the Task Force.

The SVO is now proposing a new clean amendment which is substantially similar to the original 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 they deem 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 which is lower than that of the parent based on its assessment of the parent/subsidiary relationship. However, this new 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 Statements of Statutory Accounting Principles 105R – Working Capital Finance Investments.

Proposed Amendment – The proposed text changes directing the SVO to assign NAIC Designations to WCFI programs with unguaranteed and unrated subsidiary obligors are shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2021 P&P Manual format.

PART ONE

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

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

. . .

WORKING CAPITAL FINANCE INVESTMENTS (WCFI)

Description

118. As described in *SSAP No. 105R - Working Capital Finance Investments*, WCFI represents a confirmed short-term obligation to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program for which an NAIC Designation is assigned by the SVO. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third-party investor.

Obligor

119. The Obligor for WCFI transactions is the party that purchases the goods or services that generates the original supplier receivable (which is the payable for that Obligor). The obligor must have an NAIC Designation of "1" or "2" or an NAIC Credit Rating Provider (CRP) Rating equivalent.

Unrated Subsidiaries

120. Many WCFI programs are structured in a way whereby unrated subsidiaries of a rated parent entity are involved as transaction participants, including as the Obligor. Such programs may have strong operational and strategic linkages between the rated parent entity and its unrated subsidiaries.

121. Given (i) the short-term (less than one year) payment terms of each of the underlying receivables arising from the sale of goods or services, (ii) WCFI investors' option to stop funding a working capital finance program, and (iii) the necessity of working capital finance programs to obligors due to obligors' reliance on their suppliers, the Task Force has concluded there is a low probability of default of WCFI investments. Accordingly, the Task Force deems it reasonable to establish a principle to direct the SVO, in its assessment of WCFI programs, to rely upon a parent entity's rating for purposes of determining the NAIC Designation of the overall WCFI program.

122. Solely for purposes of WCFI transactions, the Task Force directs the SVO to rely upon the NAIC Designation or NAIC CRP Rating equivalent of the obligor, subsidiary or affiliate's parent entity if the obligor, subsidiary or affiliate does not have an NAIC CRP Rating and the SVO cannot assign an NAIC Designation to it.

123. The Task Force authorizes the SVO, based on its analytical judgement and in its sole discretion, to notch such NAIC Designation down or decline to assign an NAIC Designation, based on factors including, but not limited to, whether:

a) the unrated subsidiaries or affiliates that serve as key transaction participants cannot reasonably perform the functions expected of them; and/or

b) the rated entity does not have significant documented operational control over the performance of the unrated subsidiaries or affiliates that also serve as obligors in the program; and/or

c) documentary evidence in the program documents or appended thereto does not sufficiently demonstrate the importance of the inter-relationship between the rated entity and the unrated subsidiaries or affiliates; and/or

d) the resulting NAIC Designation would, upon application of notching, be lower than an NAIC 2 Designation.

124. For the avoidance of doubt, though the Task Force directs the SVO to use the NAIC Designation or NAIC CRP rating equivalent of the obligor's parent entity, due to the SVO's authority to notch such NAIC Designation or rating, the SVO, based on its analytical judgement and in its sole discretion, may assign an NAIC Designation to the obligor which differs from the correlated NAIC CRP rating equivalent of the obligor's parent entity or choose not to assign any NAIC Designation to the working capital finance program, based on aspects of the working capital finance program which are unrelated to the relationship between the obligor, subsidiary or affiliate and its parent entity.

125. The Task Force acknowledges that reliance upon the NAIC Designation or NAIC CRP rating equivalent of the obligor's parent entity in the absence of a binding legal obligation for the parent to assume the financial obligations of the obligor, such as a guarantee, is not a generally accepted technique or methodology (as explained in "Use of Generally Accepted Techniques or Methodologies" in Part One of this Manual) and is inconsistent with the credit substitution guidelines detailed in "Credit Substitution" in Part Three of this manual, but it is directing the SVO to so rely.

NOTE: See "Working Capital Finance Investments" in Part Three for filing instructions, documentation requirements, definitions and methodology applicable to Working Capital Finance Investments.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

WORKING CAPITAL FINANCE INVESTMENTS

...

122. **Obligor** – An entity that purchases the goods or services from the Supplier and thereby generates the original supplier receivable—and which Obligor has, or can be designated, **NAIC 1** or **NAIC 2** by the SVO or has been assigned an equivalent credit rating by a NAIC CRP or, if not so designated, the SVO can assign such NAIC Designation, as directed by the VOS/TF pursuant to the "Working Capital Finance Investments (WCFI)" section in Part One of this Manual.

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Date: August 26, 2021

To: Kevin Fry, Chair, Valuation of Securities (E) Task Force

From: Dale Bruggeman, Chair, Statutory Accounting Principles (E) Working Group

RE: Referral Response: Unrated Subsidiary Obligors in WCFI transactions

Summary – Pursuant to the referral received July 28, 2021, the Valuation of Securities (E) Task Force exposed a policy change that would direct the SVO to rely upon the NAIC designation of an unrated subsidiary obligor's parent entity for Working Capital Finance Investments (WCFI), without notching for the subsidiary. A referral was provided to the Statutory Accounting Principles (E) Working Group, as a qualifying NAIC designation of the obligor is a required element for admittance of WCFI receivables under *SSAP No. 105R—Working Capital Financial Investments.*

The Working Group has considered this exposure and acknowledges that establishment of NAIC designations is within the purview of the Task Force. However, the provisions within SSAP No. 105R were established in accordance with the historical approaches utilized in determining NAIC designations which allowed the SVO to apply its credit substitution methodology as it does for other asset classes. The proposed policy would require the SVO to imply an NAIC designation to an unrated entity based on the parent entity's credit quality without guarantees or other legally-binding provisions that provide assurance that the parent will be legally or contractually obligated to financially cover the obligations of the unrated entity. Although, for a given program, and not related to the parent/sub relationship, the SVO may notch or otherwise not give a rating to that program.

If the Task Force chooses to move away from the historical application of financial analysis and use of the credit substitution methodology in determining NAIC designations for WCFI programs, the Working Group may deem it necessary to incorporate additional guardrail provisions to SSAP No. 105R as the NAIC designation of the obligor may no longer provide the intended safeguard for WCFI programs. As WCFI are complex arrangements, the credit quality of the obligor – who is ultimately responsible for satisfying the debt owed to the insurance reporting entity – is of paramount importance. Furthermore, the referral and exposure documentation memo seem to understand this dilemma, as it specifically identifies that "no generally accepted analytical technique or methodology supports the assumption that a parent entity will necessarily support its subsidiary in times of financial distress." Consideration of changes that the Working Group would deem necessary, if any, would be expected to occur after any such edits to the P&P manual are adopted.

If the Task Force chooses to move forward with the issuance of "implied" NAIC designations to unrated entities for WCFI programs, the Working Group offers the following two components for additional consideration:

1. The exposed P&P Manual language seems to contradict with SSAP No. 105R, paragraph 7. Specifically, the Task Force language identifies that the implied approach is an alternative method to obtaining an NAIC designation. If the Task Force is going to permit an implied approach to an unrated sub, then to avoid conflicts with SSAP No. 105R, this implied designation would need to be considered an "NAIC Designation." If the guidance is adopted with the inconsistency, the guidance in SSAP No. 105R requiring an NAIC designation would be the authoritative guidance. Therefore, the Working Group would recommend coordination to address any inconsistencies.

2. Although the implied designation would need to be considered an "NAIC Designation" to satisfy the requirements of SSAP No. 105R, the Working Group recommends that NAIC designations determined under the implied methodology have a specific identifier so that WCFI programs with rated obligors and unrated obligors can be separately identifiable by state insurance regulators. This is considered necessary as without this identification, regulators could erroneously conclude that an unrated obligor has been individually determined to be of high-credit quality, or that the parent entity has guaranteed or is otherwise legally obligated to pay the obligations of the unrated entity.

The Working Group appreciates the referral from the Task Force and opportunity to provide comments. Please direct any questions or responses to the Chair of the Working Group, or NAIC SAPWG Staff.

CC: Carrie Mears, Vice-Chair, Valuation of Securities (E) Task Force
Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)
Julie Gann, Assistant Director, NAIC Financial Regulatory Services
Robin Marcotte, Senior Manager II, NAIC Financial Regulatory Services
James Pinegar, Manager II, NAIC Financial Regulatory Services

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/07 - WCFI Unrated Subs/2021-050.02 SAPWG response to VOSTF on WCFI - Unrated Subs.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
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office

RE: Use of NAIC Designations by Other Regulatory Jurisdiction

DATE: December 6, 2021

Introduction – The SVO was made aware of regulators or insurers in non-U.S. jurisdictions, e.g. Bermuda Monetary Authority and Japan's Financial Services Agency, either referencing NAIC Designations in their regulatory processes or wanting to reference them. The *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) is very specific 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. Listed below are paragraphs from the P&P Manual that explain in further detail the intended, proper and authorized uses of NAIC Designations.

DISCLOSURE STATEMENT

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.

While NAIC members are the officials responsible for state insurance regulation, and while the NAIC as an association works to express regulatory consensus on issues pertaining to insurance regulation, the NAIC SVO staff has no statutory or regulatory authority.

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.

NAIC Designations are not intended to be and should not be used as if they were the functional equivalent of the credit ratings of nationally recognized statistical rating organizations or other rating organizations whose ratings are intended to be used by investors as predictive opinions of default risk.

The use or adoption of NAIC Designations by anyone other than NAIC members is improper and is not authorized by the NAIC.

PART ONE - POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE
Expression of NAIC Standards in State Law and Regulatory Processes

6. NAIC Designations and other SVO and SSG products are standards identified in the NAIC Policy Statement and Financial Regulation Standards (SFRS) that have been incorporated into state law by the States as participants in the Accreditation Program administered by the Financial Regulation Standards and Accreditation (F) Committee. Information about the F Committee and the Accreditation Program can be accessed here: www.naic.org/cmte_f.htm.

…

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

Concerns – NAIC Designations are not intended to be a public good and "…*must be interpreted by the NAIC member in context of the NAIC Financial Regulation Standards and Accreditation Program, other characteristics of the investment, and the specific financial and regulatory status of the insurance company.*" (P&P Manual, Part One, Paragraph 37). NAIC Designations are not the functional equivalent of a credit rating and must be considered within the context of the entire NAIC regulatory framework.

Recommendation – If, despite the current restrictions on the use of NAIC Designations noted above, NAIC members consider it worthwhile to have the ability to approve the use of NAIC Designations by the insurance regulators of certain non-member jurisdictions, we would recommend certain conditions be met. These conditions would include acknowledgement by the requesting regulator in a memo of understanding (MOU) (i) of the intended purposes of NAIC Designations (including that NAIC Designations are not the functional equivalent of credit ratings), and (ii) that the requesting regulator's uses may deviate from those purposes. Additionally, a formal process would need to be created, involving necessary amendments to the P&P Manual, to authorize and rescind authorization of the requesting jurisdiction. Consideration of the jurisdiction's recognition by the Mutual Recognition of Jurisdictions (E) Working Group could be another requirement of authorization. Once authorized and listed in the P&P Manual, insurers in that jurisdiction could then be given access to the SVO List of Investment Securities compiled in AVS+ and be permitted to file securities with the SVO.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/08 - Other Jurisdictions/Old/2021-051.01 Memo to VOSTF on Use of NAIC Designations by other Jurisdictions v3.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
	Eric Kolchinsky, Director, NAIC Structured Securities Group and Capital Markets
	Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office
RE:	Rating Issues and Proposed Changes to the Filing Exemption Process
DATE:	November 29, 2021

Introduction – As noted in our February 27, 2020, Issue Paper, the Investment Analysis Office has been, and continues to be, very concerned about the NAIC's extensive reliance on rating agency ratings to assess investment risk for regulatory purposes. During the Task Force's education session in October, the Securities Valuation Office's staff conducted an in-depth review of a sample of forty-three privately rated securities with resulting NAIC Designations that differed significantly from the staff's own analysis, NRSRO (nationally recognized statistical ratings organization) peers and methodology and spread implied ratings. This list was culled from a significantly larger number of privately rated securities that the staff identified as concerning. The risk assessments were materially different with the private ratings being 3-6+ notches higher than staff's estimates, as described. Such material differences in risk assessment can result in inappropriately low Risk Based Capital (RBC) for very risky assets.

Analytical Concerns – Through the filing exempt process, the NAIC relies upon credit rating provider (CRP) ratings for the vast majority of insurer investments with no oversight as to the analytical basis for those ratings, the applicability or strength of the methodology or the consistency of the resulting risk assessment across CRPs. Additionally, the SVO has not been charged with monitoring CRP ratings or authorized to use its judgement or discretion to determine how, when and if a CRP rating should be used for NAIC purposes. These concerns were raised in the Issue Paper and have only increased over time as the SVO has now reviewed these differences for the third time and our visibility into private ratings has increased.

The primary focus of staff's concern is that CRP ratings are a critical input to core NAIC regulatory functions like statutory accounting, Risk Based Capital and financial examinations. If a CRP rating does not reflect a reasonable assessment of a security's risk, then the validity of the resulting RBC ratio, that relies upon that CRP rating to determine the factor to apply to that security, may be significantly compromised. As the magnitude of rating risk assessment differences and inconsistencies increase, the resulting impact to RBC may lead to unexpected and severe capital stress on insurers during a period of economic turmoil. Such understatement of risk can be found both in the material disparities between CRP ratings of the same security, as the data below will

demonstrate, and in the practice of getting securities, which had already been assigned NAIC Designations, privately rated for purposes of lower RBC.

Walking through an example based upon the rating differences the SVO observed in its in-depth review of a sample of the privately rated securities may highlight the potential impact and risk to the NAIC solvency framework. If a life insurer held an investment with a CRP rating of "BBB" it would translate automatically, without any oversight or review, to an NAIC Designation Category of 2.B and the pre-tax RBC factor would be 1.523%. If that CRP rating was overstated by 3-notches, meaning the security's risk should have been equivalent to a rating of "BB" and an NAIC Designation Category of 3.B with a pre-tax RBC factor of 4.537%, the input to the RBC ratio will use an RBC factor that is 3.014% lower, a difference of nearly 200%. If only 5-10% of insurer investments have this level of misstated risk, the overall impact is very meaningful and material. Hopefully this real example, taken from the SVO report to the Task Force in October, shows how critically important it is to have accurate assessments of investment risk as inputs into other NAIC processes such as RBC. The RBC factors, which have been heavily studied, can easily be made meaningless if the investment risk is substantially understated. As our comparison work has shown, the risk assessments reflected in a rating can be materially different between CRPs.

Regulatory Framework Overseeing Rating Agencies – The purpose of the Credit Rating Agency Reform Act of 2006 (CRARA) was to foster accountability, transparency, and competition in the credit ratings industry. It did so by requiring rating agencies which want recognition as NRSROs to make information about their methodologies public. Congress' aim was not to create uniform rating agencies with fungible methodologies but rather to expose the differences between rating agencies and their methodologies to enable users of ratings, like the NAIC, to make informed decisions about the strengths and weaknesses of individual rating agencies' methodologies and, thereby, their ratings. Specifically, CRARA forbids the SEC from opining on the methodology of any NRSRO. The NAIC is a consumer of credit ratings but does not currently avail itself of the information that is available to make an informed decision. Instead, under current policy, every CRP rating is deemed the functional equivalent of any other, regardless of the methodology used or consistency of the ratings assigned.

Effectively, the current NAIC policy is a paradox. On the one hand we treat each CRP's ratings as fungible – that is a AAA is a AAA no matter which CRP generates it. On the other hand, we have observed gross disparities between CRP ratings of the same credit. We currently allow all NRSROs to participate in the process. If all ratings are fungible, then only one NRSRO would be required, but if different CRPs produce different ratings, then we need to make adjustments to ensure that credit information in the ratings is consistent with our RBC framework. As discussed below, we show that CRPs are not fungible.

Rating Agency Comparisons - The IAO conducted an analysis of absolute values of rating notch differences between CRPs that rated the same security. This notch difference was done for public and privately rated securities. The IAO also calculated the cross-correlations between each CRP on securities rated by both and the principal component analysis of each CRP. This is the third time staff has compared ratings between CRPs for jointly rated issues and the results of the prior comparisons were consistent to the summary in this memo. For confidentiality reasons, the summary tables included in this report have been randomly sorted to avoid identifying any specific

CRP and the letters A-G have been used instead. If there was insufficient data for a comparison, the CRP was not included in the results summary.

As can be observed in Table 1 and 2, there are significant differences between CRPs. The CRP in the column was compared to the CRP in the row (comparisons to themselves was blanked out). Their ratings were converted into a number: "AAA"=1, "AA1"=2, "AA2"=3, "AA3"=4, etc. If CRP A rated a security "AAA" and CRP C rated the same security "AA3", the notch difference would (1 - 4 = -3) and the absolute value of that security's notch difference would be 3. Tables 1 and 2, show the magnitude of the average absolute value difference. The IAO staff believe the average absolute value of rating notch differences should be less than 1.00 for NAIC purposes when benchmarked to the CRP data from the study which was commissioned and used to determine the RBC factors, as it would reflect greater analytical and methodological consistency. This rating notch difference limitation could be overcome if there were a conservative bias (i.e. lower rating).

Publicly Rated - Average Number of Absolute Value of Rating Notch Differences

CRP	A	B	C	D	E	F	G
A		0.56	0.71	0.75	1.03	1.71	0.59
B	0.56		1.09	0.96	1.13	1.44	0.76
C	0.71	1.09		1.16	1.41	1.46	0.91
D	0.75	0.96	1.16		0.60	2.50	0.68
E	1.03	1.13	1.41	0.60		1.17	2.00
F	1.71	1.44	1.46	2.50	1.17		1.02
G	0.59	0.76	0.91	0.68	2.00	1.02	

TABLE 1

Privately Rated - Average Number of Absolute Value of Rating Notch Differences

CRP	A	B	C	D	E	F	G
A		1.43	2.79	1.21	-	3.35	
B	1.43		1.36	5.00			5.00
C	2.79	1.36			-	4.50	
D	1.21	5.00			-	3.44	1.36
E	-		-	-		2.00	1.00
F	3.35		4.50	3.44	2.00		-
G		5.00		1.36	1.00	-	

TABLE 2

Another comparison was made computing the cross correlations between pairs of CRPs, Table 3 and 4. The resulting correlation coefficient is a statistical measure of the strength of the relationship between the relative movements of two variables. Correlation coefficient values can range between -1.0 and 1.0. For NAIC purposes there should be a very strong positive relationship so a negative correlation coefficient would never be used. The closer the correlation coefficient is to 1.0, the more alike are the two CRP's ratings. Correlation coefficient values less than +0.8 are not considered significant. The IAO staff believe that correlation coefficients should be greater than +0.90 for NAIC purposes when benchmarked to the CRP data from the study which was commissioned and used to determine the RBC factors, as it would also reflect greater analytical and methodological consistency. This rating correlation coefficient limitation could also be overcome if there were a conservative bias (i.e. lower rating).

Publicly Rated - Cross Correlations of Jointly Rated Securities

CRP	A	B	C	D	E	F	G
A	1.00	0.95	0.91	0.96	0.93	0.79	0.94
B	0.95	1.00	0.87	0.95	0.87	0.83	0.94
C	0.91	0.87	1.00	0.94	0.87	0.82	0.88
D	0.96	0.95	0.94	1.00	0.95	0.83	0.92
E	0.93	0.87	0.87	0.95	1.00	0.14	
F	0.79	0.83	0.82	0.83	0.14	1.00	0.71
G	0.94	0.94	0.88	0.92		0.71	1.00

TABLE 3

Privately Rated - Cross Correlation of Jointly Rated Securities

CRP	A	B	C	D	E	F	G
A	1.00	1.00	0.89	0.83		0.53	
B	1.00	1.00	1.00				
C	0.89	1.00	1.00				
D	0.83			1.00	1.00	0.98	0.75
E				1.00	1.00		0.92
F	0.53			0.98		1.00	
G				0.75	0.92		1.00

TABLE 4

The IAO acknowledges that there are fewer jointly rated private securities versus publicly rated securities because of their private nature. Nonetheless, the comparisons highlight some of the large disparities which the SVO staff shared with the Task Force in October. There has been a substantial increase in the number of privately rated securities over the past few years. When private letter ratings (PLR) securities were first formally recognized in 2018, it was estimated by

industry that there were only ~2,000 privately rated securities. In 2019, the first full year of PLR filings, there were 2,850, in 2020 there were 4,231 and the SVO estimates there will be over 5,000 PLR securities in 2021.

A third level of analysis was performed calculating the principal component analysis (PCA). PCA is the process of computing the principal components and using them to perform a change of basis on the data, sometimes using only the first few principal components and ignoring the rest. PCA is used in exploratory data analysis and for making predictive models. Graphically, PCA represents how alike or dissimilar data sets are to each other. The closer the CRPs are in the graph, the more alike they are.

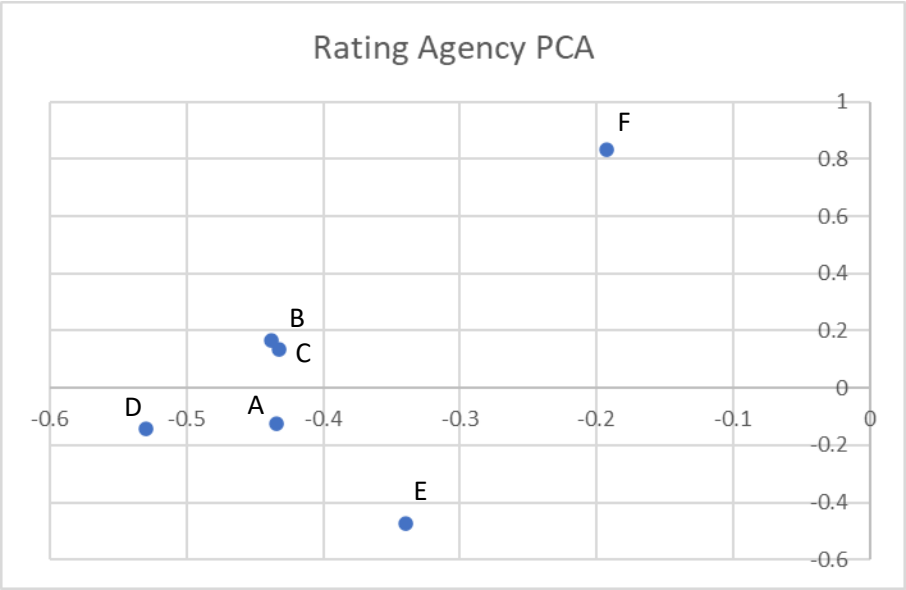

TABLE 5

Alternatives – The IAO staff believe there are at least four alternatives that the NAIC should consider in 2022 to begin the process of actively managing and overseeing its use of CRP ratings. These alternatives do not need to be considered independently and can be combined or phased in over different time periods. These alternatives are consistent with the recommendations made by the Rating Agency (E) Working in its final report dated April 28, 2010, which was subsequently adopted by the Financial Condition (E) Committee, in response to the global financial crisis of 2007-2008.

1. Require at least two (or more) CRP ratings for every security and use the lowest rating to determine the NAIC Designation. If a security has only one rating, require it to be reviewed by the SVO to determine whether the SVO deems the rating reasonable (i) pursuant to its own analysis, (ii) when benchmarked to NRSRO peers and methodology, or (iii) compared to a spread implied rating, and, if not, to determine whether a full filing and SVO analysis would be appropriate.
2. Conduct an in-depth study of the NAIC's use of CRP ratings and SVO-assigned NAIC Designations as to their consistency and comparability for regulatory purposes, specifically the determination of Risk Based Capital factors.

3. Put the CRP process under a contractual relationship by offering NRSROs the opportunity to respond to a request for qualifications (RFQ). The RFQ would look at historical coverage, consistency, persistence, comparability and predictiveness of each CRP's rating along with any other analytical and qualitative benefit they may provide to the NAIC for its regulatory purposes. Under this process, the NAIC would enter into a contract with only those CRPs that adequately meet the RFQ criteria. In many respects this process would be similar the RFP process for CMBS/RMBS.
4. The Task Force can instruct the SVO to remove any rating agency from the CRP list at any time.
5. A combination of the above – for example 1 and 4.

Conclusion and Next Steps – The IAO staff believe action is needed by the NAIC through the adoption of one or more of these recommendations to ensure that there is less variability in the assessment of investment risk reflected by NAIC Designations. Greater risk assessment variation rewards risk taking without the commensurate RBC. As the RBC example in this memo highlights, there can be potentially significant distortions of an insurer's RBC ratio if the underlying rating used to set an NAIC Designation is not derived in a manner that is comparable to or consistent with the risk assessment used in determining those RBC factors. Ratings are not interchangeable and the NAIC's use of them in its regulatory processes needs to be able to efficiently and effectively reflect those differences

The IAO welcomes industry to independently validate the general magnitude of the ratings differences for insurer held investments reported here, at least for the publicly rated securities, as historical data is available on the NRSRO websites.

cc: Jeff Johnston, Dan Daveline, Julie Gann

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/09 - Changes to FE Process/2021.052-01 Memo to VOSTF on Ratings and FE Process v6.docx