Draft date: 7/24/23

2023 Summer National Meeting
Seattle, Washington

VALUATION OF SECURITIES (E) TASK FORCE
Monday, August 14, 2023
2:00 – 3:30 p.m. PT
Hyatt Regency Seattle—Regency Ballroom B—Level 7

ROLL CALL

Member	**Representative**	**State**
Doug Ommen, Chair	Carrie Mears	Iowa
Eric Dunning, Vice Chair	Lindsay Crawford	Nebraska
Mark Fowler	Sheila Travis	Alabama
Lori K. Wing-Heier	Jeffrey Bethel	Alaska
Ricardo Lara	Laura Clements	California
Andrew N. Mais	Ken Cotrone	Connecticut
Michael Yaworsky	Carolyn Morgan	Florida
Dean L. Cameron	Eric Fletcher	Idaho
Dana Popish Severinghaus	Vincent Tsang	Illinois
Vicki Schmidt	Tish Becker	Kansas
James J. Donelon	Stewart Guerin	Louisiana
Kathleen A. Birrane	Matt Kozak	Maryland
Gary D. Anderson	John Turchi	Massachusetts
Grace Arnold	Fred Andersen	Minnesota
Chlora Lindley-Myers	Debbie Doggett	Missouri
D.J. Bettencourt	Jennifer Li	New Hampshire
Justin Zimmerman	John Sirovetz	New Jersey
Adrienne A. Harris	James Everett	New York
Jon Godfread	Matt Fischer	North Dakota
Glen Mulready	Diane Carter	Oklahoma
Michael Humphreys	Diana Sherman	Pennsylvania
Carter Lawrence	Trey Hancock	Tennessee
Cassie Brown	Amy Garcia	Texas
Jon Pike	Jake Garn	Utah
Scott A. White	Doug Stolte	Virginia
Mike Kreidler	Tim Hays	Washington
Nathan Houdek	Amy Malm	Wisconsin

NAIC Support Staff: Charles Therriault/Marc Perlman

AGENDA

Discuss and Consider for Adoption:

1. Consider Adoption of its Spring National Meeting, May 15, and July 13 Minutes (Doc. ID 2023-008.01, 2023-009.01, 2023-010.01) —Carrie Mears (IA)	Attachment One Attachment Two Attachment Three
2. Consider Adoption of its 2024 Charges (Doc. ID: 2023-007.01) —Carrie Mears (IA)	Attachment Four

Receive and Discuss Comments:

3. Proposed P&P Manual Amendment to Update the Definition of an NAIC Designation (Doc. ID: 2022-012.05, 2022-012.06b, 2022-012.07, 2022-012.08) —Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)	Attachment Five Attachments Five A-C
4. Proposed P&P Manual Amendment Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process (Doc. ID: 2023-005.01, 2023-005.02, 2023-005.03, 2023-005.04, 2023-005.05, 2023-005.06, 2023-005.07, 2023-005.08, 2023-005.09, 2023-005.10, 2023-005.11, 2023-005.12, 2023-005.13, 2023-005.14) —Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)	Attachment Six Attachments Six A–M

Hear Staff Reports:

5. Updates on the Proposed CLO Modeling Methodology and Ad-hoc Working Group —Eric Kolchinsky (NAIC)	
6. Receive a Report on the Projects of the Statutory Accounting Principles (E) Working Group —Carrie Mears (IA) and Julie Gann (NAIC)	
7. Receive Final Credit Rating Provider Questions (Doc. ID: 2022-28.02) —Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC)	Attachment Seven
8. Adjournment	

Draft: 4/10/23

Valuation of Securities (E) Task Force
Louisville, Kentucky
March 23, 2023

The Valuation of Securities (E) Task Force met in Louisville, KY, March 23, 2023. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Eric Dunning, Vice Chair, represented by Lindsay Crawford (NE); Mark Fowler represented by Sheila Travis (AL); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone (CT); Michael Yaworsky represented by Carolyn Morgan (FL); Dean L. Cameron represented by Eric Fletcher (ID); Dana Popish Severinghaus represented by Vincent Tsang (IL); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak (MD); Grace Arnold represented by Fred Andersen (MN); Chlora Lindley-Myers represented by Debbie Doggett (MO); Jon Godfread represented by Matt Fischer (ND); Marlene Caride represented by John Sirovetz (NJ); Adrienne A. Harris represented by Jim Everett (NY); Glen Mulready represented by Eli Snowbarger (OK); Carter Lawrence represented by Trey Hancock (TN); Cassie Brown represented by Jamie Walker (TX); Jon Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays (WA); and Nathan Houdek represented by Amy Malm (WI). Also participating was: Philip Barlow (DC).

1. Adopted its Feb. 21, 2023, and 2022 Fall National Meeting Minutes

Mears said the Task Force met Feb. 21 and took the following action: 1) adopted a *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) amendment to update references to 5GI; 2) adopted a P&P Manual amendment to add instructions for the financial modeling of collateralized loan obligations (CLOs); and 3) discussed a Structured Securities Group (SSG) memorandum on a proposed CLO modeling methodology (excluding scenarios and probabilities).

Kozak made a motion, seconded by Crawford, to adopt the Task Force's Feb. 21, 2023 (Attachment One) and Dec. 14, 2022 (*see NAIC Proceedings – Fall 2022, Valuation of Securities (E) Task Force*) minutes. The motion passed unanimously.

2. Received a Report on the Projects of the RBC Investment Risk and Evaluation (E) Working Group

Mears said the next item is to hear a report on projects before the Risk-Based Capital (RBC) Investment Risk and Evaluation (E) Working Group. Barlow, chair of the Working Group, provided the update.

Barlow said the Working Group met and had a very good discussion on the two main projects that are before the Working Group. The first is the long-term CLO RBC project. An update was received from the American Academy of Actuaries (Academy). The Academy continues to make good progress, and it is working to develop a modeling structure for how CLOs might be modeled for RBC purposes. This is only laying out a framework and not actually creating a model yet. This will help the Academy as it moves forward. It will continue to communicate around the modeling with the SSG, so if modeling is the way to go, the Working Group could build off the work that Eric Kolchinsky's (NAIC) team is doing on modeling. The Academy discussed how to address RBC arbitrage in the CLOs. It was decided that there is no common definition of what is meant by that. The Academy is working to develop a definition of what it means for there to be arbitrage in the RBC calculation, and it will present that to the Working Group.

The other item on the agenda is the interim solution for residual tranches. The Working Group will expose an updated structural change that includes the proposal from the Task Force, except with one bucket for the residual tranches as opposed to the three that were originally proposed. The Working Group will move ahead with the structural change and debate other aspects of the need for an interim solution. There will be a meeting that will include the Working Group, the Task Force, and the Statutory Accounting Principles (E) Working Group to look at the actual results of the annual statement filings to see where that data is. Another meeting will be scheduled to focus on the discussion of the interim proposal.

3. Discussed an Amendment to the P&P Manual to Add Instructions for Structured Equity and Funds

Mears said the next item on the agenda is to receive and discuss comments on a proposed P&P Manual amendment to add instructions for Structured Equity and Funds. This amendment was first discussed at the 2022 Fall National Meeting and exposed for a 60-day public comment period that ended Feb. 13. Three comment letters were received. One was a joint letter from the American Council of Life Insurers (ACLI), the Private Placements Investors Association (PPiA), and the North American Securities Valuation Association (NASVA); the second was from Varagon Capital Partners; and the third was from PineBridge Investments.

Mark Perlman (NAIC) said as mentioned in the Securities Valuation Office's (SVO's) memorandum and at the 2022 Fall National Meeting, Structured Equity and Funds, sometimes called "rated notes" or "feeder funds," are investments that, with the insertion of an intervening entity, such as a special purpose vehicle (SPV) or limited partnership, permit underlying assets that alone may not qualify as "bonds" or be eligible to receive an NAIC Designation under the current regulatory guidance to be reported as "bonds." This regulatory transformation is enabled because the intervening entity issues notes, and those notes receive a credit rating provider (CRP) rating. Typically, the notes are backed by equity or fund investments, some of which may have underlying bonds or loans, but the structure could just as easily be backed by any asset, including those of affiliates, non-admissible assets, real estate, mortgage loans, unrated loans, or an asset type that is ineligible to be assigned an NAIC Designation or use CRP ratings. It is possible that many of the transactions the SVO has mechanically processed as private ratings would qualify as bonds eligible for Schedule D-1 reporting according to the proposed principles-based bond definition, while others would likely not qualify.

The comment letters submitted by interested parties affirmed the SVO's primary regulatory concern. Investments in Structured Equity and Funds are oftentimes circumventing the NAIC's regulatory reporting, statutory accounting, investment risk assessment, and RBC guidance. It was noted in the comment letters that this structure was developed to be "anti-arbitrage," meaning it is intended "… to allow insurance companies to access funds with a capital charge that puts insurance company investors on a level playing field with pension funds, banks, and other non-insurance investors." In other words, the structure is intended to put insurers on a level playing field with entities subject to different regulatory regimes. The creation of investment structures for the purpose of attaining better reporting and capital treatment under the NAIC's guidance should be strongly discouraged. As communicated in the SVO's memorandum, such actions have the potential to undermine the NAIC's regulatory framework. The SVO is aware of at least one insurer using this general structure to transfer CLO Combo Notes, a type of principal protected security (PPS), an asset type expressly made ineligible for filing exemption (FE) by the P&P Manual, into an SPV that issued "rated notes" backed by those CLO Combo Notes.

Charles Therriault (NAIC) said the SVO is very sympathetic that non-life insurers do not get the RBC benefit afforded to life insurers investing in private funds with an SVO-assigned NAIC Designation, and a fund investment can be more operationally efficient, particularly for small insurers, than owning the underlying investments directly. However, if insurers do not like how an asset is treated within NAIC guidance for RBC or investment classification purposes, they should address that treatment with the appropriate regulatory group instead of creating alternate investment structures.

This amendment does not seek to alter the accounting treatment or classification for these investments, and it does not seek to set an RBC factor for them; those are the responsibilities of other NAIC regulatory groups. However, the SVO is recommending that this amendment be permitted to assess the credit risk of these investments to ensure regulatory reporting equivalency, which is the responsibility of the Task Force. These structures exploit the inherent weakness of the FE process, whereby anything with a CRP rating is assumed to be a "bond"; the rating is assumed to reflect regulatory risk concerns; and the investment is permitted to be automatically processed and assigned an NAIC Designation without any regulatory assessment of its actual risk, structure, or underlying assets. The FE process has effectively positioned CRPs as de facto super-regulators, allowing them to decide what a bond is, what its investment risk is, and by extension, what capital charge it should receive.

Perlman said some of the comment letters suggested that this amendment should wait for the Statutory Accounting Principles (E) Working Group to finish its work on the principles-based bond definition and the RBC Investment Risk and Evaluation (E) Working Group to finish its work on the RBC factors for residual tranches. As previously mentioned, each regulatory group has its own unique area of responsibility and expertise that ultimately creates the overall NAIC regulatory framework and its intentional interdependencies. While the Task Force welcomes feedback, comments, and recommendations from other regulatory groups that utilize NAIC Designations in their processes, the Task Force's action on this matter is not dependent on the completion of those projects by their Statutory Accounting Principles (E) Working Group and RBC Investment Risk and Evaluation (E) Working Group colleagues.

For example, the RBC Investment Risk and Evaluation (E) Working Group is looking at the RBC factors for residual tranches of CLOs and potentially all tranches of CLOs. The Task Force decided to remove CLOs from FE eligibility in 2024 because ratings, while potentially sound on their own, do not always lead to the appropriate outcome when applied to the NAIC's regulatory framework, and this will ensure a consistent approach to CLO designations. The Task Force's mission "… to establish and maintain all aspects of the NAIC's credit assessment process for insurer-owned securities …" and assign NAIC Designations did not need to wait for the Working Group to finish its residual and CLO RBC factor analysis, an analysis that may not have any impact on the Structured Equity and Funds' investments being discussed today.

There were also comments requesting full transparency into the methodologies the SVO would use when assessing a Structured Equity and Fund investment. When assessing insurer investments, the SVO is authorized by the Task Force in Part One of the P&P Manual to "… use any analytical technique or financial modeling approach taught in undergraduate and graduate business school financial analysis curriculum; any analytical technique otherwise widely or commonly used by lending officers, securities professionals, credit rating analysts, valuation professionals, statisticians, or members of similar professions and any special technique of modeling approach that may be appropriate in a special situation [and this next phrase is crucial] that provides a reasonable assessment of risk or valuation for regulatory purposes."

Therriault said comments compared the lack of express methodology for the Structure Equity and Funds proposal with a very transparent and collaborative process around establishing a CLO methodology. That difference in approach stems in large part from the lack of transparency afforded to the SVO with respect to Structured Equity and Fund investments and the great variety and potentially limitless permutations of these structures and the underlying assets. Structured Equity and Fund investments are not a homogeneous asset class, and they are privately issued and rated. The apportionment of risk between Structured Equity and Funds notes and equity, as well as the types of underlying investments it can hold, vary widely, all of which require the SVO to apply different approaches and methodologies based upon the structure that it is reviewing. It is not possible to produce a generic standardized methodology for what is, by its very nature, a highly bespoke transaction. Some CRPs have developed methodologies for Structured Equity and Funds, and recognizing this methodology may reasonably capture the risk. The SVO included a provision in the amendment that would permit it to consider that rating agency analysis in its review. The CLO modeling methodology benefits from several factors that permit a level of transparency that are not present for Structured Equity and Funds: 1) a broadly syndicated investment; 2) a homogeneous structure; 3) transparent publicly rated underlying investments; 4) publicly available legal agreements, and 5) widely available third-party data models and software to analyze them.

It was also noted in the comments that since the SVO is receiving private letter rating (PLR) rationale reports, it should already have sufficient transparency into Structured Equity and Fund transactions. The two examples that the SVO included in its memorandum were pulled directly from PLR rationale reports. While those reports helped the SVO identify this issue to raise up to the Task Force, they did not contain sufficient information to fully analyze the transactions or their underlying investments. The Task Force has not authorized the SVO to act on any rationale report that it sees in which it may disagree with the rating.

There seems to be a common misunderstanding around the use of CRP ratings, possibly because the FE process has been in effect for so many years. The SVO is not a rating agency, and NAIC Designations are not ratings. As directed by Part One of the P&P Manual, "An NAIC Designation must be interpreted by the NAIC member in the 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."

Other policies in Part One explain, "The NAIC uses publicly available credit ratings, when available, as one component of the services it provides to state insurance regulators concerned with financial solvency monitoring of insurance company investments. In adopting or implementing the procedure described in this section, the NAIC acts solely as a private consumer of publicly available credit ratings. The sole NAIC objective in obtaining and using publicly available credit ratings is to conserve limited regulatory resources (e.g., the resources of the SVO)."

The SVO is recommending that the Task Force add a definition for Structured Equity and Funds and remove them from the FE process, because for the reasons explained, the SVO does not believe the FE process adequately serves the NAIC's regulatory objectives for these investments. The SVO has the resources it needs through the provisions incorporated into this amendment, such as considering a rating agency's analysis of complex transactions, to provide a reasonable assessment of risk. If the Task Force wishes to limit the scope of this amendment because of the potential volume that has been suggested, the SVO would recommend restricting this to privately rated securities or those with underlying investments that are privately rated. Privately rated securities already need to be submitted to the SVO, and this would only require some additional information.

Mike Reis (Northwestern Mutual), representing the ACLI, the PPiA, and NASVA, said he wants to clarify the phrase "anti-arbitrage." It primarily relates to example one, where there was a limited partnership backed by debt instruments, that if an insurer relied upon the normal RBC charge, it would be 30%. The exposure states that the underlying debt would call for a 9% RBC charge, and that presents a similar type of arbitrage because the weighted average of the debt and equity tranche was something less, like 5%. The anti-arbitrage is that insurers want the 9% RBC charge, but they do not want the 30%. The SVO's point is that it is an RBC charge of 4% in aggregate, and it should be 9%.

The ACLI, PPiA, and NASVA struggled a little bit in responding to the letter, because there were a couple of things commingled. There were three concerns in the letter: 1) the pure regulatory arbitrage; 2) what constitutes a bond; and 3) the lack of transparency. The comment letter suggests that the first issue would be addressed with an updated residual RBC charge. That is the whole point of the residual workstream, because it is the same concern with CLOs where there is arbitrage, so this would be duplicative of that effort.

The second concern relates to the second example regarding the math not quite working in the example. That was a security that would not qualify, or at least certainly in the lower tranche, as a bond. The Statutory Accounting Principles (E) Working Group is defining what a bond is, and that should address what constitutes a bond.

PLR rationale reports are now starting to be filed with the SVO. The vast majority of these are supposedly 10, 20, and 30 pages of detailed data. The rating rationales for these two instruments are not known, but if they are not robust, that would potentially be a problem that should be addressed.

To revert to the specific two examples and just share a few other high-level thoughts of what the other members are potentially concerned about, the first is debt-backed securitization, not too dissimilar in some ways to a CLO. The group believed the residual tranche work would address the issue. The proposed solution of the SVO says there is arbitrage, which is acknowledged. If the RBC charge would be 9%, it would be hard arguing against that. The proposal said the SVO would use the weighted average rating factor (WARF) methodology, which works well in many instances. Where there are waterfall structures, the WARF methodology may not be appropriate. If the underlying debt securities are not rated, the WARF reverts to an NAIC Designation Category of 5.B. That would then result in an RBC charge that would be higher than what it should be. It does not get to the RBC charge that the underlying debt would suggest that that charge should be.

Reis said the residual tranche interim solution is intended to address this issue, and it would be duplicative. The other option is the rating agency rating could be used on that debt; industry would be fine with this as well. If neither of those work, then anything could be used to determine that charge. That is where industry likes transparency because transparency to the methodology is important. Industry has capital certainty, which is not part of what an NAIC Designation is, but as industry looks at investments to buy, capital certainty is important as industry tries to apportion capital for the investment portfolio.

If there are methodologies that the SVO consistently uses, industry would like transparency into them so industry can understand them. If there are not methodologies for every type of security structure, and it is going to be sort of an ad hoc use of them, that is troubling for industry if it is not consistent and not known. What made the examples more confusing is that there was a discussion in the exposure about paid-in-kind (PIK) interest and the potential deferral or extension of principal. There are real business reasons for those, and they are used in the portfolios much more broadly than these types of securities. The example said these could defer principal or interest without accruing interest, and it was hard to ascertain from the exposure if that "could" was used more broadly or if it related to the security in question. The comment letter states that if that is the case, industry would certainly say that is a subscript S or nonpayment risk type security. Just the fact that there are PIK or deferrals of principal, industry does not understand that concern. Raising that concern in this context alarmed many constituents.

The other example that was there was an equity-backed securitization that had ratings. It did not have a residual tranche, and it had two tranches that were rated. Quoting what Therriault said, "Just the fact that someone rates a security does not mean it is a bond." Reis said he would argue quite robustly that if there was a securitization that had two debt tranches and no equity tranche, at least with the facts that are known, it would be hard to call that a bond, certainly under the new bond standard because it is meant to have substantive credit enhancement. That seems to be more of a definition of a bond type example.

There was some trouble with the scope. The scope seemed to bring in an awful lot of securities that may not be intentional. Industry understands the no arbitrage concept, but not what else was really trying to be scoped in here or if it is anything equity-backed. There are many equity securitizations out there where the residual tranches are not even issued as part of the securitization, and it is retained. There might be 80% asset coverage, which is very thick over collateralization. The scope was what caught a lot of people's attention. This would really require the filing of quite a substantial number of securities and that it be much broader than it should be.

Mears asked if anyone from Varagon Capital Partners would like to speak to its comment letter. She said the themes in that letter were very consistent with things that Reis had just covered. Some of these rated notes, or feeder structures, are structured and tranched in ways that are similar to what is looked at with asset-backed securities (ABS) in some of the other workstreams.

Helen Remeza (PineBridge Investments) said PineBridge is an asset manager with a deep insurance heritage going back to its American International Group Inc. (AIG) days. It serves insurance companies of all sizes across the nation. Most feeder fund structures serve an important purpose; they can offer an operationally efficient way for insurers to gain exposure to certain asset classes. That also helps level the playing field across smaller insurers. That said, it is understood that there may be limited situations where potential reviews may be necessary. In the comment letter submitted, a simple framework was shared based on the SVO and SSG's proposed red flags to help identify and prioritize these cases. PineBridge supports the Task Force's mission of promoting transparency, as well as enhancing risk assessment.

Mears said a key theme that was in many of the comment letters and discussed somewhat this morning is that there are a lot of ancillary workstreams that cover this in some way. One was this review of residual tranches and the appropriate capital charge to be associated with them. Probably not in all cases, but in many cases, that may be something that mitigates some of the concerns the Task Force has. The concern, anecdotally, as residuals have been reviewed that were reported Dec. 31. 2022, is that these types of residuals are not being seen in that reporting. It is difficult to say that this will be addressed via the residual workstream when they are not being captured in the population of that workstream. There are a variety of reasons why companies that were completing their Dec. 31, 2022, statements may not have done so. Mears would like the Task Force to consider providing direction to make a referral to the Statutory Accounting Principles (E) Working Group to review how it defines the reporting for those types of annual statement lines and what types of investments are in those lines to ensure that substantively similar types of exposures are all captured together as the Working Group’s workstream continues. Crawford agreed and said she is supportive of a referral to get the appropriate reporting of these assets and securities, which is very important.

Mears directed the SVO to prepare a referral to the Statutory Accounting Principles (E) Working Group, and she said this is something that was also touched on at the RBC Investment Risk and Evaluation (E) Working Group meeting.

One of the key components of this is the transparency concern. As noted in the examples and the additional example mentioned today that was troubling, in many cases there are quite a few types of things in these structures. That is a concern that is maybe not unique to structured equity. As there continues to be an increase in private transactions and things that originated within companies, there is a lack of transparency. It is difficult, as noted by Reis, when creating a scope to just look at transactions that might be of concern, if there is not enough transparency to write a proposed amendment in such a way that it does not scope in a whole host of other investments that likely fall under very valid uses of these types of structures. Mears said she appreciates that the scoping issue is there, and there is a PLR process that is starting to receive that type of information. In fact, that is where some of these issues were identified. In some cases, complete information may not be received. What will be helpful and aligns somewhat with PineBridge's comment letter is to direct staff to create a more distinct process of how investments within that PLR population can be reviewed and perhaps have those ratings challenged. That goes back to the variety of reasons that there may be concerns, but it is not necessarily possible to say exactly what those are until there is a more transparent process. It is appreciated that industry has a concern that if you went to bed one day and had one rating and woke up the next day and had a different NAIC Designation, that may be troubling. A very distinct process on how any sort of challenging of those existing ratings that are feeding the NAIC Designation process would work. Some communication with the affected insurers and information regarding where to go from there so it is a well-understood and documented process would be beneficial, but there would be transparency needed and then communication with insurers would need to continue from that perspective. Walker said she is supportive of a transparent process when asking industry to be transparent in their investments.

Mears directed staff to document how that process could work and be brought back to the Task Force to review. It would be mostly for PLRs, since that is what is being received and available for review. Where this ends up for some of these problems today, using a stoplight example, is having only FE or not FE, or a red light or green light. Creating a yellow light option will help the process and provide more communication when there are concerns directly to those insurers involved. The Task Force is deferring any sort of adoption of this proposal, realizing that it is trying to put this other process in place and that it is well understood, to make it clear that transparency is still desired, as there are concerns about what can be in many of these structures. The Task Force recognizes that, in many cases, these concerns are extremely valid and are an efficient way for many insurers to invest, but the Task Force can also start down this path so that it is very clear how a review process will work going forward.

4. <u>Discussed Next Steps for the CLO Modeling Project</u>

Mears said the next item on the agenda is to discuss the next steps for the CLO modeling project now that the amendment to the P&P Manual to include CLO as a financial model security in Part Four has been adopted with an effective date of Jan. 1, 2024, for Dec. 31, 2023, financial statements.

Kolchinsky said based on interested party responses to the methodology exposure, staff proposed to rearrange the next step work within the ad hoc group. Specifically, the ad hoc group will first work on the prepay/discount dynamic to demonstrate the quantitative impact of these proposals on tranche losses. This will also allow interested parties to “tie-out” the model, a task we originally slated for further on in the process. Furthermore, this change will also be responsive to those interested parties who commented that it is difficult to give adequate feedback on a methodology without seeing a suite of assumptions.

The main goal for the ad hoc group will be to demonstrate the effects of prepay/discount purchases to state insurance regulators. This process should take about two months, at the conclusion of which staff and interested parties will report back to the Task Force.

Secondly, the ad hoc group will endeavor to tie out the cash flows on some “dummy” scenarios to ensure that the methodology is adequately specified in documents. Additionally, this arrangement will give time of some interested parties to propose scenarios and more of the work to occur at the RBC Investment Risk and Evaluation (E) Working Group as well.

Operationally, this work will involve three to four proxy CLO deals from industry, which will be run through Stress Scenarios A, B, and C. Please note that staff are not suggesting that these scenarios will be used in the future. They are out there for everyone to implement to tie-out the transactions.

The purpose of the ad hoc group is to resolve and clarify technical and modeling issues. Regulatory policy discussions will be limited and brought back to the Task Force.

To ensure that our time is spent productively, staff request that parties group themselves by interest and only one participant from the group speak at a given meeting. These participants can change, as it is intended to make the meetings go quickly.

Otherwise, the SSG hopes to keep the meetings open, and other parties may submit their concerns in writing to the NAIC. Staff suggest that non-regulatory participants have a technical background for the discussion. Staff will run models and results to get everything set.

Staff hope that at the end of this process, interested parties will have a better understanding of the NAIC's approach to modeling CLOs, as well as have completed the tie-out of the bulk of the methodology on "dummy" scenarios. Staff do not anticipate that any of the above will change the timeline for the implementation of CLO modeling.

Mears said the approach of the ad hoc group is to ensure that this is moving forward and is efficient. Having a collection of speakers, a process used in a few other projects across different groups, is really helpful. It is incredibly important to keep the discussion itself tight. If at some point it feels like the group is losing some sort of efficiency because there are too many voices in the room, the Task Force reserves the right to review this process and see if it is something that needs to have more of a closed group that reports back to the Task Force. This is a great way to start, as there are many interested folks, and the intent is certainly not to be exclusionary by any means.

Kolchinsky said the first meeting will be in about two weeks, and information and Webex links will be sent out. Industry participants are asked to think about the deals to use, as those deals should be commonly held by insurance companies and be available in modeling. One standard CLO, one CLO with a bond bucket, and one with a very large triple C bucket that has different CLOs to test was suggested.

5. Discussed Questions for NAIC CRPs

Mears said, as was mentioned at the 2022 Fall National Meeting, there has been a lot of interest in the continuing review of CRPs. There was a small ad hoc group that did work last year. The group went through some of the concerns and tried to come up with a more focused approach to move forward. That group no longer meets because the Task Force is now moving on to a regulator-only review directly with each CRP. The Task Force has made this preliminary list of questions available for feedback, and the questions are for the conversations with the CRPs. The goal is to eventually have a formalized, due diligence questionnaire. This will help inform initial conversations and any later due diligence questionnaires. The questions reflect the range of issues that have been discussed by the ad hoc group. Feedback on these CRP questions before those meetings are scheduled is appreciated, which is why they have been included in the materials. Comments can be sent back to SVO staff or Mears. The CRP questions will not be publicly exposed for comment to allow CRPs to privately provide comments. The Task Force will look at those comments and potentially re-arrange our questions or at least be aware of where there are differences. Some of that can come up with individual conversations with CRPs. Before scheduling those meetings, the Task Force will publish the final list of CRP questions. There will be a 30-day deadline for comments on the CRP questions, and those comments can be sent to SVO staff or Mears.

6. Discussed a Proposed P&P Manual Amendment to Update the Notice of Credit Deterioration for the List of Qualified U.S. Financial Institutions

Mears said the SVO maintains the *List of Qualified U.S. Financial Institutions* (QUSFI), which indicates the financial institutions eligible to issue letters of credit pursuant to the *Credit for Reinsurance Model Law* (#785). The letter of credit can be used to reduce an insurers liability when ceding reinsurance to certain assuming insurers. There are detailed instructions in Part Two of the manual. Perlman will provide a summary of this amendment.

Perlman said the SVO encountered a recent situation in which financial institutions on the QUSFI, namely Silicon Valley Bank and Signature Bank, were closed by their primary regulators and placed in Federal Deposit Insurance Corporation (FDIC) receivership prior to rating agencies taking action and downgrading them below the minimum permitted ratings of BBB-/Baa3 in the QUSFI guidelines in Part Two of the P&P Manual. These situations accelerated very rapidly, and regulatory actions occurred before any rating actions. The proposed amendment would recognize that regulatory actions, either announced or taken, by a financial institution's primary regulator would necessitate removal from the QUSFI. The proposed additional text would read:

> If a financial institution on the List of Qualified U.S. Financial Institutions is closed by and/or placed in receivership or conservatorship, or notice is given of such action, by its primary regulator(s), the SVO shall promptly remove the name of the financial institution from the List of Qualified U.S. Financial Institutions. This may result in the SVO being unable to provide Notice of Credit Deterioration.

Given the recent situation, the SVO would recommend a very short exposure period of 15 day if there are no objections by the Task Force, followed by an email vote with a simultaneous referral to the Reinsurance (E) Task Force. Mike Monahan (ACLI) said the ACLI is comfortable with the shortened comment period.

Mears directed staff to expose the proposed P&P Manual amendment to update the Notice of Credit Deterioration for the QUSFI to include actions by the financial institution's primary regulator for a 15-day public comment period ending April 10, with an e-vote to occur shortly afterwards and a referral to be sent to the Reinsurance (E) Task Force.

7. Received the Annual Report from the SVO on Year-End Carryover Filings

Mears said the next item is to hear the annual report from the SVO on carryover filings.

Therriault said as required in Part Two, Operational and Administrative Instructions Applicable to the SVO, of the P&P Manual, the SVO director must prepare a report for the Spring National Meeting identifying an acceptable annual rate of carryover filings for the year-end reporting period. These carryover filings can be identified with the administrative symbols "IF," which are initial filings with a self-assigned NAIC Designation, and "YE," which are annual update filings the SVO has not yet reviewed, and the NAIC Designation from the prior review was carried forward until the current year review is complete. There were 1,199 carry over filings in 2022 versus 828 carryover filing for 2021 and 795 in 2020; 381 were "IF" and 818 were "YE." This represented a carryover rate of 9.2% for 2022, versus a carryover rate of 6.7% for 2021 and a carryover rate of 6.3% for 2020. Overall, the SVO reviewed 12,983 security filings in 2022 versus 12,258 security filings for 2021. A carryover rate below 10% is manageable for the office, given its current staffing, and the 2022 carryover rate is getting close to that threshold. As of March 15, there were 258 remaining carryover filings to review.

There has been a continued rapid growth in privately rated securities. In 2019, the first year the SVO received PLRs, there were 2,850; in 2020, there were 4,231; in 2021, there was 5,147; and in 2022, there were 6,792. The SVO is also seeing a very large number of privately rated securities that are being self-reported without the required general interrogatory (GI) administrative symbol that would be added to the "PL" symbol so they can be identified in the annual statements as PLGI. Self-reporting in the GI without the administrative symbol is only permitted for a very narrow set of securities within the definition of the P&P Manual. The SVO wants to encourage insurers to follow the reporting instructions for the permitted uses of the PLGI.

The office continues to need additional technology resources. Some progress is being made on projects that were delayed for several years. Specifically, the multiple security identifiers that have been mentioned for a number of years using the Global Instruments Cross Reference Service (GICRS) dataset so the SVO can utilize the International Securities Identification Numbering (ISIN) identifier. There are probably other enhancements that could be made that would benefit both NAIC staff and insurers if there were additional resources. Those projects have had to be indefinitely deferred given the current support level.

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

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

Julie Gann (NAIC) provided a brief update on some of the items in accordance with the coordination initiative. There are two adoptions specifically to note that occurred at the Spring National Meeting. The first was the clarification of what constitutes an affiliate in an investment. The language that was adopted indicates that any invested asset that is held by a reporting entity that is issued by an affiliated entity or which includes the obligations of an affiliate entity, is an affiliated investment, and that is a clarification that goes back to the related party guidance adopted last year.

The Working Group also adopted a new disclosure for 2023 to capture information on aggregate deferred interest and PIK interest, which is something that was discussed earlier this afternoon by the Task Force. Again, this is an aggregate disclosure. It will be required for year-end 2023. The Working Group is moving forward with the blank's exposure shortly after the national meeting, and it will be data-captured. Granular information on a specific investment-level detail is planned as part of the bond project, but this will be an aggregate footnote disclosure for this year-end.

Regarding exposures, the Working Group is moving forward on the principles-based bond definition. At this national meeting, the Working Group exposed revisions to the authoritative Statements of Statutory Accounting Principles (SSAPs). Most of the revisions are limited at this point in time; the term used was window dressing. The Working Group is proposing to incorporate the guidance for residuals in *SSAP No. 21R—Other Admitted Assets*. There was a question with that exposure to industry from state insurance regulators asking how residuals have been amortized in the past and how other than temporary impairments (OTTIs) have been determined. That will assist staff in drafting language for those investments in SSAP No. 21R.

The Working Group also exposed a proposed concept for Schedule BA new reporting lines. This mirrored the guidance that exists now for certain joint ventures, limited liability corporations (LLCs), and partnerships, where there are two reporting lines for each classification of non-debt securities that do not qualify as bonds to separate them between those that have SVO-assigned designations and those that do not. The Working Group is hoping to get comments on that, consider those comments, and then sponsor a blanks proposal in the next round.

Regarding the principles-based bond definition, the Blanks reporting changes for Schedule D, which is about 200 pages long, was exposed by the Blanks (E) Working Group during its meeting in lieu of the Spring National Meeting, and the comment deadline for that is June 30.

The Statutory Accounting Principles (E) Working Group exposed guidance for collateral loans to clarify that if there is a collateral loan, it can only be admitted if the collateral that is pledged to support that collateral loan qualifies as an admitted invested asset. That means if it is a joint venture; LLC; partnership; or something that would qualify as a subsidiary, controlled, or affiliated (SCA) entity, it must be audited in accordance with *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* and *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*, but the comparison to the collateral loan will be based on audited net equity value instead of fair value.

There was also exposed guidance to incorporate the financial modeling of CLOs, which was adopted by the Task Force, into *SSAP No. 43R—Loan-Backed and Structured Securities*.

The Working Group discussed negative interest maintenance reserve (IMR). There is no exposure for this at the moment. The Working Group directed two referrals, one to the Life Actuarial (A) Task Force and one to Capital Adequacy (E) Task Force, and it directed NAIC staff to put together some guidance for a subsequent exposure, which is planned for after the national meeting.

There are three other informational updates. For those who purchase the *Accounting Practices and Procedures Manual* (AP&P Manual) via Bookshelf, there will be a portable document format (PDF) that comes with it that is available through Account Manager. The PDF will come with Bookshelf, so there is no additional charge. It is available for download now via the 2023 updates for industry.

The Working Group asked for feedback by April 15 from state insurance regulators so that it could respond to the Valuation of Securities (E) Task Force's referral regarding the acquisition of data so it could do an analytical analysis. Once that feedback has been received, the Working Group will respond with a referral letter.

Lastly, on the editorial listing, Gann said there is a proposal to remove the specific location references to the P&P Manual in the AP&P Manual. The AP&P Manual will still refer to the P&P Manual when it is appropriate, but the proposal would delete all the Part One, Part Two, and Part Three references because it sometimes gets out of sync.

Stolte asked to go back to the Working Group's referral in item #2, and he questioned if the Task Force contemplates delaying the work on the interim solution for the residuals. Mears said what the Task Force identified as something that will potentially be discussed in a regulator-only session when reviewing the results that came out of reporting is that the reporting may not be complete or it may be under-reported just to ensure that whatever decision is made by the Working Group, whether in the short term or long term, is being used for the correct population. The Task Force does not anticipate this affecting the speed of any decisions.

Reis asked Therriault to repeat the numbers for the PLR filings and the comments about the PLGI. Therriault repeated the PLR filing numbers, and he said there are permitted uses for the PLR GI reporting or PLGI under specific scenarios. It appeared in the 2022 filings that there were securities issued in 2022, which would not have been permitted to use the PLGI and would need to be reported to the SVO. The SVO did not receive a PLR in any capacity, either the electronic feed or physically, which is filed in the VISION system. The SVO does not have a match up to a PLR, and the securities were not identified as a PLGI, which probably would not have been permitted anyways. These securities were reported as a PL security, which would not be permitted, so it is a compliance issue with the P&P Manual.

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-08 Summer NM/Minutes/VOSTF 3.23.23 Spring NM Minutes (v5.1 FINAL).docx

Draft Pending Adoption

Draft: 6/12/23

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> *The VOS/TF is resolved that the benefit obtained from the use credit rating in state regulation of insurance must be balanced against the risk blind reliance on credit ratings. To ensure the Task Force properly understands the composition and risk of the filing exempt securities population; promote uniformity in the*

production of NAIC Designations, reduce reporting exceptions for filing exempt securities and increase the efficiency of this NAIC process, the SVO and SSG (hereafter, the IAO) is charged with administration of the filing exempt process defined in Part Three of this Manual."

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

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

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

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

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

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

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

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

Draft Pending Adoption

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

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

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

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

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

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

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

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

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

Draft Pending Adoption

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

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

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

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

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

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

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

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

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

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

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

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

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

5. Discussed Other Matters

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

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

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

Draft Pending Adoption

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

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

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

SharePoint/NAIC Support Staff Hub/Committees

Draft: 8/1/23

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Draft: 7/25/23

2024 Proposed Charges

VALUATION OF SECURITIES (E) TASK FORCE

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

Ongoing Support of NAIC Programs, Products or Services

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

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

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

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

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

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

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

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

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

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

J. Establish criteria to permit staff's discretion over the assignment of NAIC designations for securities subject to the filing exempt process (the use of credit rating provider ratings to determine an NAIC designation) to ensure greater consistency, uniformity and appropriateness to achieve the NAIC's financial solvency objectives.

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

NAIC Support Staff: Charles Therriault, Marc Perlman

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-08 Summer NM/02-Proposed 2024 Charges/2023-007.01 VOSTF_Proposed_2024_Charges.docx

SVO

NAIC
NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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

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

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

RE: Proposed Amendment to Update the Definition of an NAIC Designation in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)

DATE: April 26, 2023

Summary – NAIC Designations are currently explained and defined in both Parts One and Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the "P&P Manual"). The SVO proposes both consolidating these explanations and definitions in Part One only and clarifying the meaning of an NAIC Designation including their use, purpose and risk addressed.

When the new format for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) was adopted on November 16, 2018 and published in the new format on April 7, 2019, several changes were made in an attempt to simplify the P&P Manual. It has since become apparent that some of those changes have led to the interpretation that there are two meanings of an NAIC Designation: one meaning, found in Part One, applicable to all securities, whether assigned NAIC Designations pursuant to the Filing Exemption process or by the Securities Valuation Office ("SVO") and a second meaning, found in Part Two, applicable only to securities assigned NAIC Designations by the SVO. It is the SVO staff's belief that there is only one definition of an NAIC Designation and that it is applicable however the NAIC Designation is assigned. To that end, the revisions proposed in this amendment have consolidated the instructions that define an NAIC Designation to make a single uniform definition and includes updates to the definition to address questions and concerns raised about the purpose of NAIC Designations versus credit rating provider ratings.

Additionally, the SVO recommends consolidating the current "NAIC Designation Subscript S" section in Part Two into the revised NAIC Designation section in Part One because the application of a Subscript S to an NAIC Designation for other non-payment risks signifies a change in the meaning of the NAIC Designation and is a policy of the Task Force.

Recommendation – The majority of the amendment involves moving text from Part Two, the Operational and Administrative Instructions Applicable to the SVO, into Part One, the Policies of the NAIC Valuation of Securities (E) Task Force. Additionally, the amendment would add clarifying language to the newly combined explanation and definition of NAIC Designations. A clean version of the amendment has also been included to simplify the review, with the new text also clearly highlighted.

Proposed Amendment - The proposed text changes to the P&P Manual are shown below with additions in red font color and deletions in ~~red strikethrough~~, as it would appear in the 2022 P&P Manual format. Editing notes have been added with [ ] to explain section moves. New text is highlighted in yellow.

(VERSION WITH CHANGES DISPLAYED AND ADDITIONS HIGHLIGHTED)

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

. . .

~~NAIC Designations~~

[Editing note: moved from Part One, paras. 37-39 to the new "NAIC Designations" section within Part One]

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

- ~~Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.~~
- ~~Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.~~
- ~~The ability of an insurance company to realize payment on a financial obligation can be affected by factors not related to credit risk or by the manner in which the repayment promise has been structured.~~
- ~~NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk.~~
- ~~An NAIC Designation must be interpreted by the NAIC member in context of the NAIC Financial Regulation Standards and Accreditation Program, other characteristics of the investment, and the specific financial and regulatory status of the insurance company.~~

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

~~**NOTE**: See "Production of NAIC Designations" in Part Two.~~

~~**Other Non-Payment Risk in Securities**~~

39. ~~The result of the SVO's analysis of securities for other non-payment risk is expressed by the assignment of an NAIC Designation Subscript S and the application of the notching procedures described below.~~

    ~~**NOTE**: See "NAIC Designation Subscript S" and "SVO Notching Guidelines" in Part Two.~~

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NAIC DESIGNATIONS

~~Definitions~~ Use and Purposes of NAIC Designations

88. **NAIC Designations** are proprietary symbols of the NAIC. The SVO, the SSG and, under certain circumstances, insurers, produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/TF in this Manual. NAIC Designations identify a category,~~ or band of credit risk,~~ or gradations of credit quality ~~and credit risk~~ identified by the **NAIC 1** through **NAIC 6** symbols, except when accompanied by the NAIC Designation Subscript S, denoting Other Non-Payment Risks, further discussed and defined in this Manual.
[Editing note: Moved from Part Two, para. 18]

89. **NAIC Designations** reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default.

90. **NAIC Designations** are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law *[Editing note: Moved from Part Two, para. 18]* 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. *[Editing note: Moved from Part One, para. 37]* ~~NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual.~~ *[Editing note: Deleted from Part Two, para. 18]*

91. **NAIC Designations** must also be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) and other NAIC guidance. For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.

92. ~~**NAIC Designation** – Means any one of the gradations of credit quality and credit risk identified by the **NAIC 1** through **NAIC 6** symbols further discussed and defined in this Manual and may reflect notching pursuant to one or both of the notching procedures discussed in this Manual. NAIC Designations are proprietary symbols of the NAIC to be used by the SVO and SSG or under certain circumstances by an insurer to denote a category or band of credit risk.~~
[Editing note: Originally in Part One, para. 88]

~~NAIC DESIGNATIONS~~ RISKS ADDRESSED BY NAIC DESIGNATIONS

[Editing note: moved from Part One, para. 37]

93. The NAIC's ~~SVO's~~ analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation and Designation Category that ~~is~~ may be notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations and Designation Categories, as defined in this Manual, describe a credit quality-risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk, described below, except when accompanied by the NAIC Designation S~~s~~ubscript S, denoting Other Non-Payment Risks ~~described below~~.

- Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.
- Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.
- The ability of an insurance company to realize payment on a financial obligation can be affected by factors not related to credit risk or by the manner in which the repayment promise has been structured. NAIC Designations may be adjusted to reflect Other Non-Payment Risks, as described in this manual.
- An NAIC Designation shall reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default. It will also reflect consideration to potential "tail risks" (e.g. the probability that a security's payment default will be more than three standard deviations from the mean is greater than what is shown by a normal distribution).

- NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk, though these other risks may be reflected in Other Non-Payment Risks, as described in this manual.

NAIC DESIGNATION SUBSCRIPT S (OTHER NON-PAYMENT RISK)

NAIC Designation Subscript S

94. 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.
[Editing note: Moved from Part One, para. 90]

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

Description of Other Non-Payment Risk

95. 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.
[Editing note: Moved from Part Two, para. 33]

96. 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.
[Editing note: Moved from Part Two, para. 34]

97. 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).
[Editing note: Moved from Part Two, para. 35]

98. 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 dates (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.

  [Editing note: Moved from Part Two, para. 36]

- The governing agreements permit irregular or conditional payments that are incompatible with the notion of an issuer making periodic scheduled payments of interest and repaying principal in full to the insurer on a date certain;

  Illustration – A Principal Protected Security, as defined in Part Three of this Manual.

  Illustration – A security with no contractual events of payment default.

  Illustration - A security with contractual terms that have the potential to result in payment of contractually promised interest and/or return of principal in an amount less than the original investment.

Illustration – A security with an interest payment deferral feature that does not capitalize interest into principal or permits interest deferral for greater than twenty-four months or past legal maturity.

- ~~Agrees to an exposure that has the potential to result in a significant delay in payment of contractually promised interest and/or a return of principal in an amount less than the original investment.~~
  [Editing note: Originally in Part Two, para. 37]

Directive to the SVO to Assign the Subscript S Symbol

99. The VOS/TF expressly assigns to the SVO the responsibility for assessing Other Non-Payment Risk and the authority to notch NAIC Designations and assign the Subscript S Symbol, accordingly. It does so in recognition that credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes. The VOS/TF may periodically request the SVO report to it on information the SVO gathers from its review of Subscript S securities, including, for example, volume of such securities and the types of other non-payment risks.

Meaning of the Subscript S Symbol

100. 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**.
[Editing note: Moved from Part Two, para. 38]

101. 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.~~

[Editing note: Moved from Part Two, para. 39]

~~**Other Non-Payment Risk in Securities**~~

~~96. The result of the SVO's analysis of securities for other non-payment risk is expressed by the assignment of an NAIC Designation Subscript S and the application of the notching procedures described below in this Manual.~~

[Editing note: Originally in Part One, para. 39]

~~NOTE: See "NAIC Designation Subscript S" and "SVO Notching Guidelines" in Part Two.~~

APPLICATION OF NAIC DESIGNATIONS

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

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

104. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 21]

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

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

107. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 24]

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

APPLICATION OF NAIC DESIGNATION CATEGORIES

108. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories~~, as described and defined in this Manual~~.
[Editing note: Moved from Part Two, para. 25]

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

~~**NOTE**: See "Production of NAIC Designations" in Part Two.~~
[Editing Note: Moved from Part One, para. 89.]

110. **NAIC Designation Categories** are a subset of **NAIC Designations** and are used by the VOS/TF to link the NAIC risk-based-capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.

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

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
5		C		5.C
6				6

[Editing note: Moved from Part Two, para. 26]

111. NAIC Designations and Designation Categories may be adjusted in accordance with the notching procedures described in this Manual below so that an NAIC Designation and Designation Category for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations and Designation Categories may also be adjusted by notching to reflect the existence of O~~o~~ther N~~n~~on-P~~p~~ayment R~~r~~isks in the specific security in accordance with the procedures described in this Manual associated with NAIC Designations Subscript S.
[Editing note: Moved from Part Two, para. 18]

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION

112. 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*.
[Editing note: Moved from Part Two, para. 27]

113. 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.
[Editing note: Moved from Part Two, para. 28]

114. 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.
[Editing note: Moved from Part Two, para. 29]

115. 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.
[Editing note: Moved from Part Two, para. 30]

116. 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. *[Editing note: Moved from Part Two, para. 31]*

117. 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.
[Editing note: Moved from Part Two, para. 32]

~~**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.
[Editing note: Moved from Part Two, para. 32]

NAIC General Interrogatory

118. **NAIC 5GI** and NAIC Designation Category **NAIC 5.B GI** is assigned by an insurance company to certain obligations that meet all of the following criteria:

- Documentation necessary to permit a full credit analysis of a security by the SVO does not exist or an NAIC CRP credit rating for an FE or 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.

[Editing note: Moved from Part One, para. 91]

NAIC PLGI

119. Effective July 1, 2018, insurance companies shall be responsible for providing the SVO copies of private rating letters for PL securities, where applicable, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs. For PL Securities issued prior to January 1, 2018, if an insurance company cannot provide a copy of the rating letter to the SVO due to confidentiality concerns and the rating is not included in a CRP credit rating feed (or other form of direct delivery from the NAIC CRP), the insurer shall report such securities on such securities' General Interrogatory to be developed for this purpose (i.e., a PLGI security). *[Editing note: Moved from Part One, para. 92]*

Monitoring of SVO-Designated Securities

120. The SVO shall monitor, on an ongoing basis through the information provided by insurers as required by the Material Credit Events Filing described in this Manual, improvements and deterioration of credit quality of securities that are not filing exempt. *[Editing note: Moved from Part One, para. 93]*

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

~~PRODUCTION OF NAIC DESIGNATIONS~~ [EDITING NOTE: MOVED TO PART ONE "NAIC DESIGNATIONS".]

~~NAIC DESIGNATIONS~~

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

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

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

~~21. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

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

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

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

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

~~NAIC DESIGNATION CATEGORIES~~

~~25. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories, as described and defined in this Manual.~~

~~26. NAIC Designation Categories are a subset of NAIC Designations and are used by the VOS/TF to link the NAIC risk-based-capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.~~

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

~~**NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION**~~

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

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

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

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

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

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

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

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

~~NAIC DESIGNATION SUBSCRIPT S~~

~~Description of Other Non-Payment Risk~~

~~33. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.~~

~~34. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.~~

~~35. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a schedules basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).~~

~~36. Using the broad concepts identified above, non-payment risk may be present when:~~

- ~~A reporting insurance company takes on a participatory risk in the transaction;~~

  ~~*Illustration – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.*~~

- ~~The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;~~

  ~~*Illustration – A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.*~~

  ~~*Illustration – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity dates (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.*~~

37. ~~Agrees to an exposure that has the potential to result in a significant delay in payment of contractually promised interest and/or a return of principal in an amount less than the original investment.~~

~~Meaning of the Subscript S Symbol~~

38. ~~An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows:~~ ~~**NAIC 2S**~~.

39. ~~The SVO shall assess securities for other non-payment risk:~~

    - ~~Routinely, for any security or financial product filed with the SVO.~~
    - ~~As part of the analysis of a security or financial product submitted to the SVO under the RTAS – Emerging Investment Vehicle process discussed in of this Manual.~~
    - ~~When requested to do so by any state insurance regulator acting pursuant to this Manual, and:~~

      ~~*When requested by the VOS/TF; or*~~

      ~~*In support of any other NAIC group engaged in the analysis of investment risks in new securities.*~~

~~**NOTE**: See "NAIC Designation Subscript S" in Part One.~~

(CLEAN VERSION WITHOUT CHANGES DISPLAYED WITH ADDITIONS HIGHLIGHTED)

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

NAIC DESIGNATIONS

Use and Purposes of NAIC Designations

88. **NAIC Designations** are proprietary symbols of the NAIC. The SVO, the SSG and, under certain circumstances, insurers, produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/TF in this Manual. NAIC Designations identify a category, or gradations of credit quality identified by the **NAIC 1** through **NAIC 6** symbols, except when accompanied by the NAIC Designation Subscript S, denoting Other Non-Payment Risks, further discussed and defined in this Manual.

89. **NAIC Designations** reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default.

90. **NAIC Designations** are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law 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.

91. **NAIC Designations** must also be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) and other NAIC guidance. For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.

RISKS ADDRESSED BY NAIC DESIGNATIONS

92. The NAIC's ~~SVO's~~ analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation and Designation Category that is ~~may be~~ notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations and Designation Categories, as defined in this Manual, describe a credit quality-risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk, described below, except when accompanied by the NAIC Designation Subscript S, denoting Other Non-Payment Risks.

- Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.
- Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.
- The ability of an insurance company to realize payment on a financial obligation can be affected by factors not related to credit risk or by the manner in which the repayment promise has been structured. NAIC Designations may be adjusted to reflect Other Non-Payment Risks, as described in this manual.
- An NAIC Designation shall reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default. It will also reflect consideration to potential "tail risks" (e.g. the probability that a security's payment default will be more than three standard deviations from the mean is greater than what is shown by a normal distribution).
- NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk, though these other risks may be reflected in Other Non-Payment Risks, as described in this manual.

NAIC DESIGNATION SUBSCRIPT S (OTHER NON-PAYMENT RISK)

NAIC Designation Subscript S

93. 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.

Description of Other Non-Payment Risk

94. 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.

95. 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.

96. 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).

97. 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 dates (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 periodic scheduled payments of interest and repaying principal in full to the insurer on a date certain;

  Illustration – A Principal Protected Security, as defined in Part Three of this Manual.

  Illustration – A security with no contractual events of payment default.

  Illustration - A security with contractual terms that have the potential to result in payment of contractually promised interest and/or return of principal in an amount less than the original investment.

  Illustration – A security with an interest payment deferral feature that does not capitalize interest into principal or permits interest deferral for greater than twenty-four months or past legal maturity.

Directive to the SVO to Assign the Subscript S Symbol

98. The VOS/TF expressly assigns to the SVO the responsibility for assessing Other Non-Payment Risk and the authority to notch NAIC Designations and assign the Subscript S Symbol, accordingly. It does so in recognition that credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes. The VOS/TF may periodically request the SVO report to it on information the SVO gathers from its review of Subscript S securities, including, for example, volume of such securities and the types of other non-payment risks.

Meaning of the Subscript S Symbol

99. 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**.

100. 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.

APPLICATION OF NAIC DESIGNATIONS

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

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

103. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

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

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

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

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

APPLICATION OF NAIC DESIGNATION CATEGORIES

107. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories.

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

109. **NAIC Designation Categories** are a subset of **NAIC Designations** and are used by the VOS/TF to link the NAIC risk-based-capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.

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

110. NAIC Designations and Designation Categories may be adjusted in accordance with the notching procedures described in this Manual below so that an NAIC Designation and Designation Category for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations and Designation Categories may also be adjusted by notching to reflect the existence of Other Non-Payment Risks in the specific security in accordance with the procedures described in this Manual associated with NAIC Designations Subscript S.

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION

111. 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*.

112. 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.

113. 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.

114. 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.

115. 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.

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

NAIC General Interrogatory

117. **NAIC 5GI** and NAIC Designation Category **NAIC 5.B GI** is assigned by an insurance company to certain obligations that meet all of the following criteria:

- Documentation necessary to permit a full credit analysis of a security by the SVO does not exist or an NAIC CRP credit rating for an FE or 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.

NAIC PLGI

118. Effective July 1, 2018, insurance companies shall be responsible for providing the SVO copies of private rating letters for PL securities, where applicable, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs. For PL Securities issued prior to January 1, 2018, if an insurance company cannot provide a copy of the rating letter to the SVO due to confidentiality concerns and the rating is not included in a CRP credit rating feed (or other form of direct delivery from the NAIC CRP), the insurer shall report such securities on such securities' General Interrogatory to be developed for this purpose (i.e., a PLGI security).

Monitoring of SVO-Designated Securities

119. The SVO shall monitor, on an ongoing basis through the information provided by insurers as required by the Material Credit Events Filing described in this Manual, improvements and deterioration of credit quality of securities that are not filing exempt.

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June 29, 2023

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

Re: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "P&P Manual" or "the Manual") to Update the Definition of an NAIC Designation in Parts One and Two of the P&P Manual

Dear Ms. Mears:

The undersigned (ACLI, PPIA, SFA, and NASVA) appreciate the opportunity to comment on the exposure referred to above that was released for comment by the Valuation of Securities Task Force (VOSTF) on May 15, 2023. We generally like to provide constructive comments on VOSTF exposures and provide support wherever possible. However, the undersigned are confused on the intent, scope and potential impact of this exposure, as it relates to the Definition of an NAIC Designation and Subscript S Non-Payment Risk. The commingling of these two issues, without any significant, robust documented rationale or transparency of the potential impact, leaves the undersigned guessing as to the impact and precludes us from providing more targeted comments.

The undersigned are concerned about the proposed expansion in scope of Securities Valuation Office (SVO) responsibilities, without transparency as to the rationale and impact of the specific proposed changes, the specific processes that will be impacted related to the proposed changes, and the issues surrounding the differentiation between individual security risk and portfolio risk. This view is substantiated by the conclusions of an extensive study commissioned by the VOSTF, following a non-transparent SVO initiative related to trust preferred securities. The capital market disruption that followed the trust preferred securities actions resulted in a congressional inquiry, and VOSTF commissioned a study from a subgroup of the Investment Analysis Working Group that among other things:

- Was part of the NAIC's transparency initiative, which was necessary to minimize future problems, and
- Focused on examining individual security risks versus portfolio risks

We support NAIC initiatives to address market innovation but believe transparency is important and historical lessons learned should not be forgotten. The report is included as Attachment A, and we will refer to both transparency and individual security risk throughout this letter.

That study concluded that credit risk is separate and distinct from multiple other identified risks, including event, liquidity, call, extension, deferral, and currency risks. In its Exhibit Three it also describes how these non-credit risks were addressed in the regulatory framework. Among those on the working group expert panel were regulators, NAIC staff and accounting, actuarial and investment professionals. Insurance industry trade associations were not included.

We understand weekly meetings (some day-long) were held beginning in January 2008 and continued at least through May. The final report was submitted in August 2008.

Ultimately, the working group recommended improvements in asset-specific disclosures and a regular reassessment of RBC factors by the Capital Adequacy Task Force (CATF), but the working group did not recommend that the scope of risks assessed as part of an NAIC designations be expanded, because many of the other defined risks were already captured in some way within the C-1 Risk Based Capital (RBC) risk framework and not related to credit risk. The findings of the study were consistent with the current language in Part One, Item 27 of the Practices & Procedures (P&P) Manual that specifically states: "NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk." This exposure seems to be a reversal of prior NAIC policy and recommendations culminating from a very thorough analysis performed by the working group.

Definition of an NAIC Designation

In addition to Subscript S Non-Payment Risk, which we will address later in our letter, the changes to the Definition of an NAIC Designation include several changes that we believe need further and transparent review. These changes include the following:

> *89. NAIC Designations reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default.*
>
> *91. NAIC Designations must also be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) and other NAIC guidance. For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.*
>
> *92. An NAIC Designation shall reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default. It will also reflect consideration to potential "tail risks" (e.g., the probability that a security's payment default will be more than three standard deviations from the mean in greater than what is shown in a normal distribution).*

Since the exposure gives no compelling rationale as to why these changes have been made, nor to their potential impact, the undersigned request additional transparency as to their impact.

Included in paragraph 89 is the statement that NAIC Designations "reflect the timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default." The undersigned have often questioned why the SVO's and Structured Securities

Group's (SSG) designation methodology considers only the likelihood of payment default, ignoring expected recovery should a security default in payment (i.e., ignoring loss given default). Industry has spoken with multiple rating agencies, all of whom take into account expected recoveries following payment default for specific types of securities (first mortgage bonds, equipment trust certificates, enhanced equipment trust certificates and speculative grade debt, to name a few) as well as considering where debt resides within an issuer's capital stack. Likewise, bank lending also takes expected recoveries into account, with most banks strongly preferring to lend on a secured basis, recognizing the importance of collateral in reducing the overall risk position of a loan. The undersigned understand that RBC charges were initially developed using a Moody's framework, and Moody's considers expected losses, including loss given default analysis—not just a probability of default framework. The report in Attachment A highlights that Moody's and S&P factor in loss given default and recoveries as well. Therefore, the undersigned would like to understand whether basing NAIC Designations/ratings on likelihood of payment default alone (giving no consideration to potential recoveries) is incongruous with how NAIC RBC charges were developed. We propose that this matter to be formally referred to the Capital Adequacy Task Force. Specifically, CATF should assess whether the proposed language is in-line with how the NAIC's risk-based capital charges were developed, and whether it changes the meaning of an NAIC designation in a way that is incongruous with CATF's intent.

The following is from paragraph 91, "*For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security."* While the undersigned believe this phrase is rather innocuous, we believe it is appropriate to formally refer this change to CATF as well. Presumably, an NAIC designation's primary purpose (not just in "many cases") is to serve as the basis for determining the appropriate risk-based capital charge. CATF should ensure that either the reference to SFRS and "Other NAIC guidance" do not change the intent of CATF for risk-based capital and/or whether "Other NAIC guidance" needs to be explicitly and transparently defined so interpretation is not in question.

Similarly, paragraph 92 includes a new concept whereby designations should consider potential "tail risks" (e.g., the probability that a security's payment default will be more than three standard deviations from the mean is greater than what is shown by a normal distribution). This is a new concept for the P&P Manual, and limited context has been provided, leaving industry to wonder how this concept would be applied in practice by NAIC staff.

1) Does it mean that NAIC staff would assign a designation, based on expected performance under tail risk outcomes, or that staff would assign a designation based on the most likely outcomes, yet somehow give consideration to tail risk events? If the latter, how would that work?
2) If a security is rated by a Credit Rating Provider (CRP), and NAIC staff does not believe that the CRP is giving sufficient consideration to tail risk outcomes (or they disagree on what the relevant tail risk scenarios are) will staff notch that CRP rating for tail risk?
3) How does analysis of tail risk differ between structured securities and issuer obligations?
4) Is the proposal for tail risk analysis as drafted consistent with how RBC factors were determined?

The addition of tail risk analysis into an NAIC Definition raises several issues that the undersigned feel must be clearly addressed.

The undersigned again propose that this matter be formally referred to CATF, to consider whether this is in line with how the NAIC's risk-based capital charges were developed, whether it changes the meaning of an NAIC designation in a way that is incongruous with CATF's intent, and/or whether it is a departure from definitions provided for agency credit ratings, who make no such references in their definitions. Ultimately, if this concept is adopted, its definition and impact should be very explicitly and transparently documented. Insurers need to understand in practice how tail risk would be evaluated—both for structured securities and for issuer obligations.

Lastly, many references to Subscript S and liquidity have been referred to within the newly proposed Definition of an NAIC Designation. Subscript S warrants a significant and separate section within our letter.

Subscript S Non-Payment Risk

Proposed Change in Scope Regarding Subscript S Authority

The exposure was presented as a technical change intended to simplify the P&P Manual. However, the undersigned believe that combining the NAIC Designation Subscript S definition in Part Two of the P&P Manual with the definition of an NAIC Designation in Part One, as drafted, effectively expands the scope of the SVO's and the SSG's authority. Part Two of the current version of the P&P Manual clearly limits the SVO's ability to assess for Subscript S risks to transactions where the SVO assigns a Designation or where the VOSTF or a regulator request that the SVO assess Subscript S risk for a particular transaction. The undersigned believe that the P&P Manual, as currently constructed, does not allow the SVO to notch ratings assigned by CRPs. This view is further supported by the fact that there are no Blanks administrative symbols in Schedule D for an NAIC Designation that combine both the "FE" and the "S" subscripts. Administrative symbols exist for "FE" and for "S" individually, but not for "FE" and "S" in combination.

The undersigned believe that the exposure could be interpreted as granting the SVO/SSG authority, not only to identify Subscript S risks, but to notch NAIC Designations accordingly—both those assigned directly by the SVO and those assigned by CRPs. The undersigned specifically reference two parts of the exposure that lead us to believe this is the practical outcome:

1) The bullet point in Part One, Item 93 was specifically modified to add the italicized phrase highlighted in red: "NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk, *though these other risks may be reflected in Other Non-Payment Risks, as described in this manual."* The additional reference to Other Non-Payment Risks specifically modifies the scope of an NAIC designation to allow for consideration of such risks.

2) Item 99, entitled "Directive to the SVO to Assign the Subscript S Symbol" was added to the Manual as part of the exposure. This provision states that: *"The VOS/TF expressly assigns to the SVO the responsibility for assessing Other Non-Payment Risk and the authority to notch NAIC Designations and assign the Subscript S Symbol, accordingly. It does so in recognition that credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes. The VOS/TF may periodically request the SVO report to it on information the SVO gathers from its review of Subscript S securities, including, for example, volume of such securities and the types of other non-payment risks."* This additional language would effectively delegate authority for assessing Other Non-

Payment Risk to the SVO and allow the SVO to notch CRP ratings for Other Non-Payment Risk if it deems appropriate. This is a departure from past practice.

The result of these two additions could potentially allow the SVO/SSG to notch securities for Other Non-Payment Risks with limited oversight from the VOSTF or from other regulatory bodies. Furthermore, the exposure is unclear under what circumstances, and to what degree, the SVO/SSG could notch securities for Other Non-payment Risks, which raises multiple questions:

1) Would notching be applied only to non-filing exempt securities?
2) If no, would notching be applied to both privately rated and publicly rated filing exempt securities?
3) How would the SVO/SSG identify and assess these risk characteristics for both privately and publicly rated filing exempt securities? For example, would all 40-year bonds (a proposed type of Subscript S security) need to be filed "as if" they were not filing exempt, so the SVO/SSG could assess and notch for Subscript S risk? (If so, this would essentially make these securities non-filing exempt.)
4) To what degree might the SVO/SSG notch, and under what circumstances might they choose to do so? Would it be a one-notch impact, a two-notch impact, or more?
5) Would the notching methodology be documented in a methodical and transparent way?

We have had multiple conversations with regulators and SVO staff on this issue over the past 12 – 18 months, and we still do not know the answers to the above questions. We have never received straightforward, transparent answers in our discussions, nor is it clear in this latest written exposure. We have yet to understand exactly what the exposure intends to accomplish and why it is necessary.

<u>Fundamental Concerns with Subscript S Proposal</u>

We understand from discussion with both the SVO and Regulators, for example, that interest deferral may not relate to individual security risk but may be information that individual regulators would like to have. For example, individual regulators may want to ensure that such securities are factoring in liquidity risk (e.g., if there is a significant concentration of securities with deferral features) in asset adequacy testing (AAT) for an individual company. Other times, Subscript S may represent non-payment risk as defined, and we will discuss this in more detail below.

For risks that are not individual security risks, but Regulators have a desire/need for further information (e.g., deferral risk for better understanding how utilized in AAT), the appropriate solution would be to bifurcate the Subscript S definition into two categories. Subscript S tags would represent Non-Payment Risk, while a new tag could be created (call it Subscript T, for example) to reflect securities with other portfolio risks, where the SVO does not alter its designation, as it is not an individual credit risk, but where additional disclosure is needed for Regulators at the individual company level. The undersigned are very open to providing more information on portfolio risks such as PIK interest, deferrals, prepayment risk, 40-year maturities, perpetual bonds, etc., and we are willing to work with Regulators and NAIC staff to determine the best way to provide such disclosure. We just do not believe that these risks represent credit risks for which the SVO/SSG should notch securities (or deem the securities non-filing exempt, as the exposure seems to suggest.)

As noted in our previous letter dated September 12, 2022, the undersigned highlight which of the Subscript S risks identified we believe to be individual security risks versus portfolio risks. Please see the

7 illustrations within paragraph 97 of the exposure and the illustrations below that highlight responses from our previous letter. For a more fulsome response see Attachment B to this letter.

#	Illustration	Represents Non-Payment Risk (Y/N?)	Additional Comments
1	Dollar-denominated obligation in non-U.S. currency (with no exchange rate)	Yes	See original response letter for proposed edits to ensure this language is not meant to construe that all foreign denominated bonds (i.e. not a dollar denominated obligation) have non-payment risk.
2	Perpetual debt that can miss payments w/ no requirement to be repaid	Yes	But this is duplicative of both 3a and 5 below, and is better captured in 5 below more holistically.
3a	Perpetual bonds	No	We note the Working Group report in Exhibit 2 states that risk of permanence is not an individual security risk but is an example of extension risk (exhibit 2). A quick query of Bloomberg shows there are approximately $200 billion of investment grade perpetual bonds, and we would like to understand the ratinale for filing these with the SVO for designations.
3b	40+ year maturities	No	But may be important for regulators to understand at a portfolio level where disclosure is desired.
4	Principal Protected Securities	Yes (?)	Note: These are already non-filing exempt and not schedule D bonds. Are these really non-payment risk or just not filing exempt?
5	Bonds without contractual events of payment default	Yes	Recommend additional clarity be provided, as the descriptor is one sentence with nine words. The undersigned are hard-pressed to find any examples of such securities within the capital markets.
6	A security that results in less payment than the orginal investment.	Yes	Important clarification language should be added so it would not capture bonds issued at a premium--see original response letter
7a	Security with PIK or deferred interest that doesn't capitalize or otherwise accrue	Yes	
7b	Security with PIK or deferred interest than can just be defered but otherwise capitalizes or accrues.	No	This is portfolio risk. The clear intent of the VOSTF commissioned report was to separate PIK interest and other payment deferral risks from credit risk and the NAIC desigation process. This is consistent with the current drafting in the P&P Manual. Further disclosure may be merited for AAT to understand cash flow deferral risks wholistically at a portfolio level.

Conclusion

The undersigned understand Regulators' interest in clarifying the definition of what an NAIC Designation represents - and we agree. However, we believe transparency surrounding the meaning and impact of any proposed changes should be afforded to industry and all interested parties. As such, the undersigned request a formal referral to CATF to elicit such an understanding. The undersigned also understand Regulators' interest in Other Non-Payment Risks and portfolio risks, and we are willing to work collaboratively with NAIC staff and regulators to help distinguish between individual security risks vs. portfolio risks. We are very willing to provide additional blanks fields and/or footnotes, if desired by Regulators, to identify these risks and provide sufficient qualitative information to help Regulators understand implications for insurance portfolios (e.g., portfolio risks such as PIK interest, deferrals, prepayment risk, 40-year maturities, perpetual bonds, etc.). However, this is a long running issue, and we still do not have answers to basic questions. We again ask for complete transparency to our questions related to Subscript S.

The undersigned believe the separation of Subscript S between part one and part two of the P&P Manual was deliberate. This makes it all the more important to provide robust and transparent answers to the questions we lay out, so that all parties understand any new authority bestowed to the SVO. For example, if all 40 - year bonds (which we do not believe represent non-payment risk) must now be filed with the SVO for NAIC Designations, then this is a significant change that should be transparent. (These bonds are not currently filed with the SVO.) Ultimately, the undersigned believe this exposure conflates portfolio risks and other non-payment risks with credit risk.

For securities that the undersigned believe truly represent non-payment risk (see table above), we could support those securities being filed with the SVO for a NAIC designation, similar to PPS. For the remaining types of securities listed in the chart above, which the undersigned do not believe represent individual security non-payment risk, but instead represent portfolio risk (e.g., PIK interest, deferral and extension risk, or 40-year bonds, perpetual bonds, etc.), we support disclosure so individual regulators can use as needed (e.g., in assessing if reflected in AAT). This would eliminate the concept of notching altogether – a concept for which there seems to be much confusion. Developing a common understanding of these issues amongst Regulators, the SVO, and all interested parties, needs to happen via a robust and transparent process. The undersigned stand ready to assist in this matter, and we welcome continued dialogue and questions.

Sincerely,

M Monahan	Tracey Lindsey		John Petchler
Mike Monahan	Tracey Lindsey	Michael Bright	John Petchler
ACLI	NASVA	SFA	on behalf of PPiA Board of Directors

cc: Charles Therriault, Director, Securities Valuation Office
Eric Kolchinsky, Director, Structured Securities Group

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

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

The Private Placement Investors Association ("PPiA") is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PPiA serves 66 member companies and works with regulators, NASVA, the ACLI, the American College of Investment Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace. For more information, visit www.usppia.com.

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

The Structured Finance Association is the leading securitization trade association representing over 370 member companies from all sectors of the securitization market. Our core mission is to support a robust and liquid securitization market and help its members and public policymakers grow credit availability and the real economy in a responsible manner. SFA provides an inclusive forum for securitization professionals to collaborate and, as industry leaders, drive necessary changes, advocate for the securitization community, share best practices and innovative ideas, and offers professional development for industry members through conferences and other programs. For more information, visit www.structuredfinance.org.

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Attachment -1
Report of the Risk Subgroup of the IAWG

Memorandum

To: Invested Asset Working Group
From: Risk Subgroup of the Invested Asset Working Group
Date: August 26, 2008
Subject: Review of Investment Risks

This is the report of the Risk Subgroup of the NAIC Invested Asset Working Group (IAWG). The Subgroup was formed to evaluate all investment risks to determine which risks are individual security risks for fixed income securities and to review how those individual security risks are handled in the current NAIC regulatory framework.

The need to undertake the review of investment risks stemmed from the events that followed the hybrid security decisions taken by the NAIC in 2006. The issues were finally resolved by the adoption of the American Academy of Actuaries (AAA) report by the NAIC earlier this year. A full review of all possible investment risks by the IAWG, as part of the NAIC's transparency initiative, was necessary to minimize future problems.

To the extent that the Subgroup observed deficiencies, it would recommend improvements to the IAWG. There were no boundaries on the risks that could be considered as part of the deliberations. The Subgroup consisted of the following regulators and industry representatives:

Max McGee, Prudential, Chair of the Risk Subgroup
Chris Anderson, Anderson Insights
Bob Carcano, NAIC Securities Valuation Office (SVO)
Kevin Fry, Illinois Department of Insurance
Wally Givler, Northwestern Mutual
Trond Odegaard, Allstate
Matti Peltonen, New York Insurance Department
Ruth Sayasith, MetLife
Elaine Weiche, Connecticut Department of Insurance

Aside from the subgroup members listed above, significant input was also provided by Allen Elstein (Connecticut), Jeff Evans (SVO) and Jim Everett (New York).

Although a member of the Subgroup may be associated with a particular company or insurance department, his or her participation in the Subgroup was as an individual, in a professional capacity, rather than representing their company or state. The subgroup was composed of participants with various specialties including: regulatory, financial/capital markets, risk management, actuarial and accounting/reporting.

Risk Subgroup Process

The Subgroup began its work in late January 2008 and conducted weekly conference calls to discuss issues regarding investment risks. The calls did include other regulators from the states represented on the Subgroup, NAIC staff and the SVO. However, the Subgroup members made all decisions regarding the content of the report. All conference calls were documented and the Subgroup members approved minutes of the calls. There was a full and complete discussion of the issues during those calls.

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The focus of the Subgroup was fixed income securities only. We began the process by developing a list of all potential investment risks. Our initial list included approximately twenty risks and it swelled to almost thirty as we worked through the process. We used a very deliberate process to discuss each risk on our list. We focused on risks associated with individual securities and not portfolio risks although we did discuss portfolio risks during our deliberations.

We first discussed and arrived at a definition for each risk. Based on that definition, we determined whether a particular risk was an individual security risk. Some risks were discussed and disposed of quickly. Other risks took several calls to reach a conclusion. Ultimately, each risk discussed ended up on one of two lists (Individual Security Risk or Not an Individual Security Risk).

Any discussion of fixed income investment risks should include a discussion of interest rate risk as that risk can fundamentally alter the return of a fixed income instrument. Although interest rate risk was determined not to be an individual security risk but rather a systematic risk, we did discuss it in some detail.

Whenever possible, we considered existing definitions for the risks identified rather than creating new definitions. The definitions may have been changed slightly to reflect the insurance context. The sources used were the NAIC and the Federal Reserve System Joint subgroup on Financial Issues from June 2003 and textbooks such as The Handbook of Fixed Income Securities by Frank Fabozzi.

Discussion of Investment Risks

The Subgroup reviewed twenty-eight potential individual security risks, and through a full and detailed discussion, determined that eight of these risks were present in fixed income securities. The eight risks are credit, event, liquidity, call, extension, deferral, currency and leverage. After discussing all of the risks identified, the Subgroup agreed that there were no material additional individual security risks related to fixed income securities. We also discussed Financial Innovation, which is covered in more detail in Exhibit 4.

There are four additional attachments to this report which supplement our written report. Exhibit 1 provides a summary of the risks that were determined to be individual security risks along with a definition for each risk. Exhibit 2 is a listing of the balance of the risks covered as part of our deliberations, which were determined not to be individual security risks. Exhibit 3 is a grid that describes how each of the eight risks determined to be individual security risks are addressed in the current regulatory framework and recommendations to further improve the regulatory process. Exhibit 4 is Jeff Evans' report on how the ratings of rating agencies reflect loss and recovery given defaults as part of the ratings process.

Credit Risk

Credit risk is the risk of non-performance of contractual payment obligations on bonds, cash equivalents and other invested assets with the characteristics of fixed income instruments. As part of our discussions, we covered the history and development of C-1 (Asset Risk) in the RBC formula and how that relates to credit risk.

The American Academy of Actuaries (AAA) performed a review of default history in the early 1990's in order to develop the AVR and C-1 factors. The AAA utilized the Moody's default statistics as part of that review to classify securities into six rating categories. The study resulted in recommendations on the factors regardless of cause for default.

We also discussed whether the definition should be modified, as it does not explicitly state that there is a risk of downgrades of debt instruments which could lead to greatly reduced market values well before scheduled maturity dates or defaults. It was observed that the C-1 factors contemplated defaults (using a ten-year horizon) and that as an asset is downgraded RBC factors will increase and marking-to-market may even be required. Still, this does not address whether the possibility of downgrades should be stated explicitly in the definition. Ultimately, the Subgroup concluded that the present definition was adequate, however, following the concept that adverse developments for the investor with respect to any risk factor should be expected to result in market price declines for the asset and as such credit risk was not materially different from other risks identified in this regard.

Our conclusion is that C-1 covers the risk of default and is synonymous with credit risk. Credit risk is an individual security risk. Defaults are cyclical and the factors used in C-1 should be reviewed by the NAIC on a periodic basis. We did determine that default experience is reflected in ratings provided by the rating agencies.

We recommend that the Capital Adequacy Task Force review the default studies periodically (at least once every five years or more frequently as circumstances dictate) to determine whether material changes have occurred. Based on that review, a more in-depth study of default experience may be warranted.

Deferral Risk

Deferral risk is the risk of the issuer's right to delay payments of interest or dividends (temporarily or indefinitely) on certain instruments. It was noted that the impact of deferral is already explicitly incorporated in rating agency credit ratings and is also covered as an element of C-1. Deferral risk is required to be disclosed in the bond characteristics codes in Schedule D.

Event Risk

Event risk is the risk of regulatory changes or other external actions or occurrences that are significant and unanticipated, and which impact the value of a security. It includes governmental actions that limit payments from borrowers that are otherwise willing and able to fulfill their obligations. Some examples of event risk are corporate restructuring, takeovers or changes in tax or accounting treatment of an investment as well as natural disasters. Actual or potential corporate restructurings and takeovers, in particular, may have an adverse impact on the holders of fixed-income securities in a number of ways. In general, the impact of an event can be immediate or gradual over time.

Event risk is not a risk that is included in the credit ratings of individual hybrid and other securities, according to papers by the SVO and Standard & Poor's. This is because it is generally believed that it is impossible to factor in predictions of surprise events, such as corporate restructurings and major changes to accounting or regulation, into the ratings of individual securities. Because the factors for AVR and RBC C-1 are intended to set levels for entire portfolios of securities, the impact of defaults caused by unexpected events is actually included in AVR and RBC, even though individual ratings do not reflect event risk. This is because the historical studies that formed the basis for AVR and RBC looked at the occurrences and consequences of all defaults regardless of cause, so if an unexpected event caused a default then that event was included in the calibration of C-1. This is consistent with the understanding that all factors that cause defaults are contemplated by AVR and C-1, and factors that do not cause defaults (such as foreign currency risk) are not included in AVR or C-1 risk factors.

Liquidity Risk

Liquidity risk is defined as the risk that an investor will not be able to buy or sell an asset into the market with the expected bid/ask spread, anticipated price continuity or sufficient depth, thus causing price realization or execution that is unfavorable or nonexistent. The Subgroup agreed that liquidity is both a portfolio level risk as well as an individual security risk. Liquidity risk could also change over time based on the occurrence of certain events that could make the security less liquid.

Liquidity risk is addressed in the Examiners Handbook as part of the risk-focused examination approach. The Subgroup believes that liquidity risk is a significant risk and recommends, at a minimum that, the NAIC Financial Analysis Handbook be reviewed and potentially strengthened to better address portfolio liquidity risk.

Call Risk

Call risk is the risk that an issuer may elect to retire an asset, in whole or in part, when the investor would have preferred that the asset remain outstanding. Call risk and extension risk are closely related.

Call risk is currently addressed for life insurers through asset liability management, statutory cash flow testing and RBC C-3 Phase I. Call risk is required to be disclosed in the bond characteristics in Schedule D for all insurers but the details of the call provisions for a security are not readily available to state insurance regulators. Provisions should be made for facilitating access by regulators to the specific call features, possibly by including them in the SVO database project.

Extension risk

Extension risk is the risk that an issuer may elect not to retire an asset, in whole or in part, prior to its maturity date when the investor might have anticipated and might have preferred early retirement.

Extension risk is currently addressed for life insurers through asset liability management, statutory cash flow testing and RBC C-3 Phase I. Extension risk is required to be disclosed in the bond characteristics in Schedule D for all insurers. Provisions should be made for facilitating access by regulators to the specific extension features, possibly by including them in the SVO database project.

We also discussed how mortgage-backed securities are impacted by call and extension risk. In the case of mortgage-backed securities, the cash flow depends on the timing of principal repayments made by the borrowers in the pool of mortgages that serve as collateral for the security. Prepayment risk is the risk that borrowers will prepay all or part of their mortgage sooner than anticipated. Extension risk is the risk that prepayments will be slower than anticipated.

Currency Risk

Currency risk is the risk that a nondollar-denominated bond (i.e., a bond whose payments occur in a foreign currency) has uncertain U.S. dollar cash flows. The dollar cash flows are dependent on the foreign exchange rate at the time the payments are received.

Payments linked to foreign exchange rates are required to be disclosed in the bond characteristics codes in Schedule D. The Subgroup believes that currency risk is adequately disclosed in the annual statement, but recommends that the IAWG review the disclosures for potential enhancement.

Leverage Risk

Leverage risk is the risk associated with increasing the volatility of periodic payments. Using leverage, principal repayment terms also may be structured to increase their uncertainty, which increases credit risk. Security specific leverage is generally accomplished through structuring periodic payments according to formulae.

Rating agencies consider the risk of credit leveraging when assigning a rating to a security or a tranche of a structured security. Therefore, the risk of credit leveraging would be captured through the C1 (Credit Risk) component of the life RBC formula. In the situation where periodic payments (e.g. interest payments) may be leveraged, modeling of the security in C-3 Phase I of the life RBC formula would capture the impact of leveraging of periodic payments of the security in the Asset-Liability mismatch risk.
Leverage risk is required to be disclosed in the bond characteristics codes in Schedule D which identifies when the insurer can vary the amount of periodic payments.

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Other Considerations

- We also discussed the Bond Characteristics (Schedule, D Part 1, Column 5) and their development during the implementation of Provisional Exemption to enhance disclosure. Realizing that credit ratings referred only to default risk (and its costs), IAWG members sought a mechanism to flag risks other than credit risks. Disclosure of these risks (call, foreign currency *etc*.) for each individual asset was considered at the time to be an enhancement to the explicit reliance on ratings based solely on credit as the basis for AVR and C-1. The IAWG should consider expanding the Bond Characteristic codes to enhance disclosure and transparency.

- It was pointed out during our discussions that we need to be thinking about the cumulative effect of a specific risk across a number of asset classes. It could be more significant than just an individual security.

- There were also seventeen additional risks that were considered as part of our discussions. Those risks are outlined in Exhibit 2. The discussion on most of those risks was very short since the Subgroup members quickly agreed that they were not individual security risks. In some instances, the risks were already embodied in the eight risks that were deemed to be individual security risks. In many instances, we agreed that they represented legitimate risks but were not individual security risks. The details on the risks deemed not to be individual security risks are documented in Exhibit 2 (further details are contained in the minutes from the meetings which are included in the Appendix).

- We had an interesting discussion on conversion risk. If a security has a mandatory conversion provision, it is treated in RBC as if it had already converted so the risk is addressed from a solvency supervision standpoint. If the conversion is not mandatory, there is no incremental risk because the conversion is at the investor's option. We concluded that conversion risk does not warrant further attention at this time but this should be documented in our work product.

Recommendations

The Risk Subgroup recommends:

- The Capital Adequacy Task Force should review the default studies periodically (at least every five years or more frequently if circumstances dictate) to determine whether material changes have occurred. Based on that review, a more in-depth review may be warranted.
- The NAIC Financial Analysis Handbook should be reviewed and potentially strengthened to better address portfolio liquidity risk.
- The IAWG should consider expanding the current database project by the SVO, or other alternatives to address regulators concerns about additional data on call and extension characteristics of specific securities.
- The VOS Task Force should consider expanding the Bond Characteristics codes to incorporate additional needs of regulators to identify attributes of securities.
- The Subgroup believes that currency risk is adequately disclosed in the annual statement, but recommends that the IAWG review the disclosures for potential enhancement.

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Exhibit 1

Individual Security Risks

Credit risk is the risk of non-performance of contractual payment obligations on bonds, cash equivalents and other invested assets with the characteristics of fixed income instruments.

Event risk is the risk of regulatory changes or other external occurrences that are significant, unanticipated and external, which impact the value of a security.[1]

Liquidity risk is the risk that an investor will not be able to buy or sell an asset into the market with the expected bid/ask spread, anticipated price continuity or sufficient depth; thus causing price realization or execution that is unfavorable or nonexistent.

Call risk is the risk that an issuer may elect to retire an asset, in whole or in part, when the investor would have preferred that the asset remain outstanding.[2]

Extension risk is the risk that an issuer may elect not to retire an asset, in whole or in part, prior to its maturity date when the investor might have anticipated and might have preferred early retirement.

Deferral risk is the risk of the issuer's right to delay payments of interest or dividends (temporarily or indefinitely) on certain instruments.

Currency risk is the risk that a nondollar-denominated bond (i.e., a bond whose payments occur in a foreign currency) has uncertain U.S. dollar cash flows. The dollar cash flows are dependent on the foreign exchange-rate at the time the payments are received.

Leverage risk is the risk associated with increasing the volatility of periodic payments. Using leverage, principal repayment terms may be also structured to increase their uncertainty, which increases credit risk. Security specific leverage is generally accomplished through structuring periodic payments according to formulae.[3]

[1] Includes governmental actions that limit payments from borrowers that are otherwise willing and able to fulfill their obligations.
[2] In the case of mortgage-backed securities, the cash flow depends on the timing of principal payments made by the borrowers in the pool of mortgages that serve as collateral for the security. Prepayment risk is the risk that borrowers will repay all or part of their mortgage sooner than anticipated. Extension risk is the risk that prepayments will be slower than anticipated.
[3] As an example of leverage risk under this definition, Inverse Floating Rate instruments may be used to lever the risk and returns of periodic payments (*e.g.*. interest payments). Other instruments, such as Collateralized Debt Obligations, or CDOs, can be used to lever credit risk (as defined herein) and the effect of this leverage is reflected in rating agency ratings, NAIC Designations and C-1 factors.

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Exhibit 2

Risks Not Considered as Individual Security Risks

Conversion risk of a mandatory convertible security is not an individual security risk.

Systemic or systematic risk is not an individual security risk because it relates to classes of securities, securities markets or even broader market place.

Reinvestment risk is not an individual security risk but is considered a portfolio risk.

Refinancing risk is not an individual security risk and is already covered in call and extension risk.

Prepayment risk is part of call and extension risk.

Political risk is not an individual security risk and is already considered as part of event risk.

Sovereign risk is not an individual security risk and is already considered as part of event risk.

Recovery risk is not an individual security risk since it already covered in credit risk. This was confirmed in discussions with rating agencies and by reviewing their documentation.(See Exhibit 5)

Risk of permanence is not an individual security risk but is an example of extension risk.

Option risk is already addressed in other risks (call, extension and leverage).

Market risk is not an individual security risk since it is the sum of all the other individual security risks which have already been identified.

Reinsurer risk.

Counterparty risk.

Lack of accountability risk.

Yield-Curve (Maturity) risk.

Inflation risk.

Market manipulation risk.

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Security Specific Investment Risks and the Insurance Regulatory Framework

EXHIBIT 3

Risk	Manner in which addressed in the 2008 regulatory framework	Recommendations
Credit	Covered through C-1	Capital Adequacy Task Force should review the default studies periodically (at mininium every five years) to determine whether material changes have occurred. It is important to note that the default studies by their nature are backward-looking and need to incorporate low probability/high severity events (such as a depression). These studies should be reviewed periodically since financial innovation may impact future experience.
Event	Covered through C-1 in the aggregate if it results in default In other cases not addressed since it is unanticipated The balance of the risk is addressed in C-4 for life insurers.	None
Liquidity	Important at the portfolio level and how it impacts the insurance company Not explicitly addressed in current structure for RBC or reporting Companies use varied internal calculations to monitor liquidity Risk-focused exam can be a platform for examining and assessing company liquidity practices	NAIC Financial Analysis Handbook needs to be reviewd and potentially strengthed to address liquidity risk.
Call	Covered through ALM and C-3 Phase I for life insurers only. Covered through statutory cash flow testing for life insurers. Required to be disclosed in the bond characteristics codes in Schedule D.	Provisions should be made for facilitating access by regulators to the specific call features, possibly by including them in the SVO database project.
Extension	Covered through ALM and C-3 Phase I for life insurers only. Covered through statutory cash flow testing for life insurers Required to be disclosed in the bond characteristics codes in Schedule D.	Provisions should be made for facilitating access by regulators to the specific extension features, possibly by including them in the SVO database project.
Deferral	Covered through C-1, see reports from AAA and Hybrid RBC Working Group It is noted that NRSROs rate for significant deferral risk Required to be disclosed in the bond characteristics codes in Schedule D.	None
Currency	Payments linked to foreign exchanges rates are required to be disclosed in the bond characteristics codes in Schedule D.	The Subgroup believes that currency risk is adequately disclosed in the annual statement, but recommends that the IAWG review the disclosures for potential enhancement.
Leverage	Required to be disclosed in the bond characteristic codes in Schedule D and identifies where the issuer can vary the amount of periodic payments. The risk of credit leveraging is addressed in C-1.The leveraging of interest rate risk is addressed in C-3 Phase I of the life RBC formula.	None

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Exhibit 4

Financial Innovation

The members of the Subgroup considered the risks related to financial innovation (a/k/a financial engineering, financial structuring), including modeling risk, information risk, and complexity risk. Fixed income investments subject to such risks include, but are not limited to: callable/escrowable municipal bonds, municipal inverse floaters, auction rate securities (ARS), mortgage backed securities (including pass-throughs, CMOs, IOs/POs and other MBS variants), asset backed securities, and cash market and funded synthetic collateralized debt/loan obligations (CDOs/CLOs). Any security that is not a straightforward non-callable bond would be subject to some degree of the risks attendant to financial innovation. However, a true statement for the general category may not be true (in a practical sense at least) for an individual security in that category. For example, a cash market AAA CDO tranche would arguably have less risk under almost all conceivable circumstances than the underlying pool of collateral, financial engineering notwithstanding. Further, a true statement for the general category may not be true for an individual security when considered in an asset portfolio context – for example, MBS IOs (which may be used as a tool to reduce portfolio duration – arguably reducing interest rate risk). These examples begin to illustrate the challenge of a one-size-fits-all approach, or a security specific approach, to characterizing financial innovation risk.

As evidenced by the instruments listed above, financial innovation is not a new market phenomenon. Relative to non-callable fixed income instruments, financially engineered instruments generally require more sophisticated analysis (including modeling) and more information to properly characterize their expected cash flows, the risks associated with timely (either premature or belated) and complete receipt of these cash flows, and as events have recently unfolded, in some cases, their liquidity. The members of the sub-group were in general agreement that financial engineering risk is, at least conceptually, security specific. For instance, the risks presented by student loan ARS are completely different from the risks presented by funded synthetic corporate CDOs, and derive from the respective nature of the underlying collateral and the structure of the instruments. Analysis of the risk, therefore, naturally requires an understanding of the specific characteristics of the instrument in question. However, comprehensive characterization of the risks generally extends beyond instrument specifics, and for many instruments includes an underlying interest rate simulator/generator (generally monte carlo or lattice based, depending on the particulars of the instrument). Interest rate simulators are at the heart of many fixed income instrument risk analyses, and their implementation involves as much judgment and skill as the modeling of the specific instruments. In some cases, the nature of the instrument requires modeling of default correlations – a non-security specific (more accurately a cross security) parameter. These realities complicate a myopic focus on the security specific aspects of the risk in question.

There was considerable debate within the sub-group regarding whether financial innovation represents an individual security risk or an operational risk. However, there was agreement that it is a legitimate concern and should be addressed within the regulatory framework. The sub-group felt that is less important that financial innovation be characterized as an individual security risk, than it is for regulators to have a process to identify securities that are so affected, so that they can engage companies in further dialogue about how they manage the risks often attendant to these securities.

Summarizing the preceding, the general sense of the sub-group is that 1) the risks presented by financial innovation represent a legitimate concern worthy of regulatory attention, 2) while aspects of the risk are security specific, a security specific approach to addressing such risk is incomplete and otherwise problematic, and 3) a more appropriate approach to handling financial innovation risk is to regard it as a subset of operational/management risk, and to improve the regulatory review of management processes and expertise. Further, the sub-group recommends that the IAWG consider ways to make improved security information more readily available for regulator use, perhaps through the Bond Characteristics column of Schedule D.

National Association of Insurance Commissioners

Securities Valuation Office

Exhibit 5

Recovery Ratings and Loss Given Default Assessments
How Standard & Poor's and Moody's Incorporate Recovery and Losses Following Default in Their Ratings Processes

Prepared by:

Jeffrey L. Evans, CFA
NAIC SVO
IAWG subgroup on Risks
07/24/2008

Both of the two largest NRSROs incorporate recovery analysis (S&P) or loss given default assessments (Moody's) in their below investment grade corporate ratings. Essentially, in their efforts to incorporate recovery in default, both rating agencies notch lower (usually) or higher (less frequently) from the baseline probability of default rating. Thus, the issue rating as published is a blend of the strict probability of default, combined with recovery of the investment in the event of a default.

The notching is based on the agencies' assessments of what proportion of the face value of the obligation a debt holder is likely to receive on their investment should the issuer default on its obligations. These assessments are influenced by three main factors: 1) the quality of the collateral of the issuer overall; 2) by the relative size of the claim relative to the collateral; and 3) the order of priority of claim in the capital structure that each issue represents. An issue backed by substantial collateral, that is higher in priority, will be notched higher; while one backed with little or no collateral, that it lower in priority, will be notched lower

Conceptually, this means that between two issues with the same rating (say "B+/B1" rated senior subordinated bonds of ABC and XYZ); one (XYZ) might actually be more likely than the other (ABC) to default. In default, however, expected recovery on XYZ would be higher than ABC.

The methodologies by which the two rating agencies arrive at their conclusions are very different in process, if not so greatly different in outcome. For a discussion on the agencies' respective methodologies, see S&P "Corporate Ratings Criteria 2008", available at:

http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/2,1,1,4,1204836634695.html[1]

"Probability of Default Ratings and Loss Given Default Assessments for Non-Financial Speculative-Grade Corporate Obligors in the United States and Canada" is available at:

http://www.moodys.com/cust/content/loadcontent.aspx?source=staticcontent/free%20pages/LGD/lgdadpage.htm[2]

What follows is an examination of the hypothetical case above, following the steps that end with identical ratings, but with different probabilities of default and corresponding different levels of expected recovery.

For the two issuers, ABC and XYZ, to have identical issue ratings but with different probabilities of default, they must have different baseline or enterprise level ratings. In S&P's nomenclature, this is called a Corporate Rating, or an Issuer Rating.

[1] Free registration is required. Once logged in, click "Research and Knowledge/Criteria & Methodologies/Ratings – Corporates.
[2] Free registration is required. Once logged in, this report is listed under "Reports" dated August 23, 2006.

National Association of Insurance Commissioners

Securities Valuation Office

Moody's calls it their Corporate Family Rating. In the case of ABC, imagine that it has an Issuer rating of "BB+" from S&P and a Corporate Family Rating of "Ba1" from Moody's. XYZ, on the other hand, has an S&P issuer rating of "B" and a corporate family rating from Moody's of "B2." In this case ABC and XYZ baseline or enterprise level ratings are four notches apart, with ABC rated higher. It is interesting to note that using Moody's published historical default statistics, a "B2" rated bond has a nearly 36% likelihood of defaulting over 10 years, while for a "Ba1" rated bond the likelihood of default over 10 years is just over 10%.

Let us assume that ABC is a company that has relatively little collateral for bondholders to claim in the event of a default. ABC could be a services company that is rated on the basis of its cash flow. Let us further assume that there is a substantial amount of debt on ABC's balance sheet that is senior to the issue in question. Should ABC default, what little collateral there is would be claimed by the senior debt holders, leaving nothing for the issue we are looking at. In this case, both S&P and Moody's might notch ABC's senior subordinated debt *lower* by two steps, to "BB-/Ba3."

With the other issuer, assume that XYZ, although lower rated, has good collateral for the bondholders. Perhaps it is a company with more leverage, or a weaker competitive position, but one that has valuable and marketable assets for collateral. XYZ might be an independent oil producer with proven oil reserves in its portfolio, reserves that would fetch a good price from another buyer. Let us further assume that XYZ has very little debt on its balance sheet that is senior to the issue in question. Were XYZ to default, the senior subordinated investors could expect to receive the full face value of their investment, because the collateral coverage is so strong. In this case, both agencies might notch XYZ's senior subordinated debt *higher* by two steps, to "BB-/Ba3."

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September 12, 2022

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

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

Dear Ms. Mears,

The undersigned (ACLI, PPiA, NASVA) appreciate the opportunity to comment on the exposure, referred to above, that was released for comment by the Valuation of Securities Task Force (VOSTF) at the NAIC Summer National Meeting.

The undersigned are also appreciative that the Securities Valuation Office (SVO) was willing to work with industry to try and gain a mutual understanding of non-payment risk to the new additions and existing language being proposed, including with PPNs, and significant progress was made. However, we are still concerned with various aspects of the proposal.

Relevant Background Information

The proposal references at least three parts (parts one, two and three) of the P&P Manual. The proposal itself proposes changes to part two but defers proposed changes to part three. Our comments reflect the assumption that the de facto second phase of this proposal would be to make subscript S securities non-filing exempt. This is an important assumption that is reflected in our comments.

Further, our comments reflect the fact that the P&P Manual at times can be very difficult to navigate due to its complexity and often conflicting guidance. For example, this was illustrated by the second item, of the July 28, 2022 summer national meeting agenda, where the SVO itself highlighted several conflicting statements in relation to clarifying its role in relation to Interpreting Accounting and Reporting. This proposal was ultimately adopted with the support of industry. Our comments here attempt to simplify and avoid unproductive debate on potentially conflicting or ambiguous language in the P&P Manual.

In simple terms, we understand Subscript S to mean any security that has non-payment risk in addition to the credit risk of the issuer. We believe this provides a more readily available foundation rather than trying to include the many references and inferences within the P&P Manual that may be confusing or contradictory.

More specifically, we note that the P&P Manual (paragraph 37) notes that an NAIC designation reflects credit risk does but does not measure prepayment, extension, or liquidity risk. Paragraph 37 is the foundational language in the P&P Manual describing what an NAIC Designation measures.

Eight Proposed Illustrations of Subscript S Non-Payment Risk

Our approach is to offer perspective on each of the eight illustrations being proposed and address where we believe there is (or isn't) non-payment risk that should ultimately cause a security to no longer be filing exempt and/or where the language is ambiguous or unclear.

Illustration 1 – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield 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.~~

Non-payment risk – We agree that this illustration highlights a security that has non-payment risk. This describes a dollar denominated bond whereby the payment at maturity, is denominated in US dollars, whereby repayment may not be repaid in full because it depends upon an exchange rate.

However, we suggest the highlighted (i.e., shown with a strike through) language be removed for clarity purposes – i.e., so as to ensure that language is not meant to construe that all foreign denominated bonds (i.e., not a dollar denominated obligation) have non-payment risk. Foreign denominated bonds are funded in a foreign currency with the expectation that both interest and principal will be received in the same foreign currency. Further, the majority of such insurance company investments are hedged for foreign currency risk. Therefore, any notching by the SVO would be inappropriate.

Illustration 2 – 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.

Non-payment risk – We agree that this illustration represents a security that has non-payment risk. Essentially, by allowing a perpetual security that can miss scheduled interest or dividend payments that are not required to be paid on a subsequent date, such a security could be construed as permanent equity-like capital and would not meet the requirement of a bond for NAIC purposes.

Illustration 3 – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity date (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.

No Non-Payment Risk – This illustration appears to address two distinct items:

1 - Perpetual Bonds – Perpetual bonds have contractual terms that require perpetual interest payments (e.g., a perpetuity). There is no risk beyond credit risk that needs to be assessed. The accounting for perpetual bonds is being determined by SAPWG. Where accounted for as bonds, they are required to be reported at fair value. Further, if the credit quality is affected, such credit deterioration is reflected in risk-based capital in two different ways – a lower credit rating and lower risk-based capital due a lower value through fair value accounting.

2 – Bonds with maturities equal or exceeding 40 years – 40-year bonds are quite common, including from household names (e.g., Apple and Microsoft, etc.), for which insurance companies invest. These are used, in part, to match insurance company liabilities with expected payments that are 40 years or even greater. Just recently Union Pacific Corporation issued a 50-year bond. Moreover, many insurance companies have invested in 100-year bonds from prominent universities (e.g., Yale, MIT, Tufts University, California Institute of Technology, etc.). There is no risk, other than credit risk, associated with these bonds. Notching such investments by the SVO, with no deterioration in credit risk, would potentially disincentivize insurance companies from prudent investment decisions.

Illustration 4 – A Principal Protected Security, as defined in Part Three of this Manual.

Non-Payment Risk – As illustrated in Part Three of the P&P Manual.

Illustration 5 – A security with no contractual events of payment default.

Non-Payment Risk – A security that has no contractual events of payment default (i.e., no repercussion due to a missed payment) has non-payment risk beyond the credit of the issuer.

~~Illustration~~ 6 – A security with contractual terms that have the potential to result in payment of contractually promised interest and/or return of principal in an amount less than the original investment amount of contractually promised interest and/or principal.

Non-Payment Risk – A security that has contractual terms that have the potential to result in payment of contractually promised interest and/or return of principal in an amount less than the original amount contracted for, have risk of non-payment beyond the credit risk of the issuer. However, to ensure there is appropriate clarity, we suggest the proposed changes shown above (e.g., proposed changes shown with strike-through and underline) to ensure the written language would not inappropriately or unintentionally capture any security issued at a premium.

Illustration 7 – A security with deferred principal payment features that are at the option of the issuer, not including grace periods of up to 30 calendar days.

No Non-Payment Risk – A security where the issuer has the right to defer principal payment (analogous but opposite to call risk) does not have additional repayment risk beyond the credit risk of the issuer (as long as the bond accrues interest during the extension period).

Many securities have the ability to defer principal payments for a year, or even longer, and can be advantageous in a securitization because it can prevent distributions in kind to an insurer. This is advantageous because the insurer does not want distributions in kind, and also wants the issuer (a loan in an over-collateralized securitization) to have operating flexibility for the best exit strategy to best maximize returns. While it may represent some degree of liquidity risk, liquidity risk is not part of an NAIC designation, and the SVO is not suited to assess the overall liquidity risk of an insurer.

Such features can also actually reduce liquidity risk by preventing distributions in kind. It may also lower credit risk, by giving the borrowing company in the securitization the needed operating flexibility to maximize returns. Extension risk is also not part of an NAIC designation. If liquidity risk and extension risk are of concern to regulators, this is best served by requiring a disclosure on schedule D where such securities can be viewed in aggregate and in the context of the whole host of other information needed to assess the liquidity risk or extension risk related to any specific insurer. Any individual security (or group of securities) may potentially create liquidity risk for one company, but not another, depending upon their products, investments holdings, etc. so notching NAIC Designations, while beyond the purview of the SVO for liquidity risk, would also be inappropriate. If it would be of value for regulators to understand the extent a company holds securities with "extension risk" in the context of liquidity risk, disclosure on Schedule D may be a more appropriate solution.

Illustration 8 – A security with interest payment deferral feature that does not capitalize interest into principal <u>(or does not require deferred interest to accrue at a compound rate</u>) or permits interest deferral, <u>that is not capitalized or compounded</u>, for greater than twelve months or past legal maturity.

Non-payment risk – Many securities have deferral of interest features that get capitalized (payment-in-kind or PIK securities) that have the advantages as described in our response to Illustration 7 but also in situations where the securitization is in the "ramp up phase" (i.e., in the process of investing in the underlying investments) and may have temporary "liquidity issues". This is viewed as a favorable feature by insurance company investors as it actually decreases overall liquidity risk. In this instance, or where interest is deferred and compounded, insurers are more concerned about being made whole and this is factored in when making the investment. This example addresses situations where the interest is not capitalized, and we agree that this presents non-payment risk beyond that of credit risk. For the sake of clarity, we therefore proposed adding the language highlighted (underlined).

However, some have expressed concern that the proposed language was intended to not imply what our proposed change would suggest – i.e., any deferral of interest, even if capitalized, for greater than 12 months presents non-payment risk. If so, we do not agree as this appears to be addressing liquidity risk which is not part of an NAIC Designation. A counter-intuitive, inappropriate and unintended result would be that this scopes in zero coupon corporate bonds, and even zero-coupon US Treasuries, which capitalize interest deferrals through the life of the bond.

Any individual security (or group of securities) may potentially create liquidity risk for one company, but not another, depending upon their products, investments holdings, etc. so notching NAIC Designations, while beyond the purview of the SVO for liquidity risk, would also be inappropriate. If it would be of value for regulators to understand the extent a company holds securities with "PIK" features, in the context of liquidity risk, disclosure on Schedule D may be a more appropriate solution.

Other Practical Issues

Requiring securities, that do not have non-payment risk, to be filed by the SVO for a designation (i.e., they would not be filing exempt) would also present the following two practical issues.

For the securities highlighted above with no non-payment risk, this would require the filing of these securities with the SVO with all the requisite documentation required for such a filing. In addition to the cost, such information may not be available to the investor as it was not contemplated at the time of investment.

Also, certain securities highlighted above with no non-payment risk (e.g., 40 year or greater maturity, PIK interest, extension risk) are of a nature that cannot be designated by the SVO (e.g., certain ABS) or are already designated by the SVO (e.g., CMBS/RMBS).

In conclusion, it is very important that any language related to Subscript S, with the expectation that such securities will eventually need to be filed with the SVO, be very clearly articulated and truly represent non-payment risk. Further, if regulators would benefit from better understanding the extent to which insurers hold securities with risks (e.g., liquidity risk, extension risk, or long maturities, etc.) which do not reflect non-payment risk, we believe disclosure of these risks on Schedule D would better assist regulators assessing such risks holistically. As Schedule D reporting is currently being revamped by SAPWG, the timing for such a solution is perfect.

We stand ready to assist regulators and staff with regards to this proposal. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

MMonahan

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey

Tracey Lindsey
NASVA

John Petchler
John Petchler
on behalf of PPiA
Board of Director

ATHENE

June 29, 2023

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

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

RE: Proposed P&P Manual Amendment to Update the Definition of an NAIC Designation

Dear Ms. Mears:

We appreciate the opportunity to comment on the above-mentioned amendment. As we stated in our June 9, 2023 letter to the Risk-Based Capital Investment Risk and Evaluation Working Group, we are concerned that the NAIC has commenced systemic changes to the regulatory capital framework without first having conducted the necessary comprehensive analysis to ensure consistency across asset classes and risks. Consumers are facing a retirement income crisis with fewer available options. Opaque regulatory capital tools, such as the revisions to the SVO's Subscript S authority, will damage insurers' abilities to invest with transparency and capital certainty. Eventually, this will unnecessarily impede insurers' ability to offer products that address the retirement income crisis. We respectfully submit that the NAIC membership should first consider and address the following broader questions that are relevant to the regulatory capital framework for life insurers:

(1) What is the specific problem that needs to be solved by this and related proposals?

(2) What are the relationships among regulators, credit rating providers (CRPs), the SVO/SSG, and insurers regarding NAIC Designations and determination of credit risk and what methods are used?

(3) Have NAIC members fully considered the legal and regulatory ramifications in assigning to the SVO powers that are a combination of both regulatory and CRP in nature?

(4) What governance is present to ensure a consistent calibration given the multiple proposals across asset classes, NAIC Designations, and charges?

(5) Does this and related proposals further the NAIC's stated 2023 priority of reducing the protection gap for an already underserved American consumer base?

(6) Have the NAIC members, through an open and transparent fiscal and governance process, fully considered the resource and budgetary needs associated with empowering the SVO to take on this and related responsibilities?

With regard to this particular technical initiative, the SVO has proposed revisions to Subscript S by (i) expanding the scope of securities to which Subscript S applies and (ii) expanding the SVO's ability to notch designations. The SVO justifies the proposal on the basis that "credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes." The amendment proposes to capture non-payment risks not designed to be included within the C-1 Framework, such as volatility/interest rate risk, prepayment, extension, and/or liquidity risk.

We can understand the logic for creating a tool to address regulatory considerations related to certain repayment features. However, we observe the following critical and unresolved issues:

- It is unclear (i) which CRP methods are deemed to be unfit for designations and (ii) what regulatory assumptions are not currently being considered by the CRPs. No data, analysis or examples have been advanced in support of the assertion that the CRPs' ratings do not appropriately consider "other non-payment" risks.
- No framework exists to consider how risk from these features might be compared to other features or methods, or to other pressing market risks not currently being studied, such as commercial real estate equity and the decreasing quality of corporate bonds over time.
- References to NAIC Designations not capturing volatility/interest rate risk, prepayment, extension, and/or liquidity risk, which are purposefully not otherwise included in C-1, suggest that the SVO proposes to capture such risks by means of notching under Subscript S.
- While the proposal references the use of NAIC Designations in RBC charges, there is no acknowledgment of other parts of the regulatory framework, such as reserving, suggesting a lack of consideration for implications to the overall regulatory framework.

When considering these concerns, the proposal should be compared against other potential effective means to address the SVO's purported regulatory concerns, such as a review of STAT and RBC frameworks and assessing possible limitations that may arise under STAT or RBC in relation to NAIC Designations based on CRPs' existing models. Eventually, with significantly increased CRP assessment and transparency, regulators should consider potential minimum standards for CRPs in lieu of or before individual security notching. A holistic framework setting forth such minimum standards for CRPs would permit state insurance regulators to challenge CRP practices not meeting regulatory assumptions and concerns, while also providing transparency to CRPs and the industry with respect to such assumptions and eliminating potentially duplicative regulatory tools (such as this Subscript S authority and the proposed SVO general authority to challenge CRP ratings).

Liquidity Risk as a Factor in Determining NAIC Designations

NAIC Designations have never been intended to measure liquidity risk. We single out liquidity as a clear example of an "other non-payment" risk that is currently and deliberately addressed through other mechanisms that apply to insurers, including asset adequacy analysis and liquidity stress testing. This separation allows the treatment of liquidity to vary across insurers' business models that have liabilities with varying liquidity needs (e.g., Property and Casualty vs Life). Including liquidity risk within NAIC Designations will inevitably lead to framework inconsistency and disrupt the intentional relationships between C-1 RBC and other parts of the regulatory framework. The Task Force should not adopt revisions to the P&P Manual that would include these risks in NAIC Designations without first consulting with other relevant NAIC committees and working groups.[1]

Scope of the Proposal

The proposed authority appears to apply to a range of structured securities, as well as high-yield corporate and certain other assets. In contrast, the Task Force's prior work on principal protected securities was more narrowly executed and excluded many types of structured securities. We do not dispute the regulatory need to gain a better understanding of these features. However, we believe that any expansion of the SVO's authority should be done in a transparent way that enunciates the specific issues, is narrowly tailored, and provides a list or specific definition of securities to which the new authority would apply. Proposing a significant change in the SVO's authority without sufficient information may cause chilling effects in the market, resulting in lost price transparency and income, ultimately impacting policyholder benefits. We strongly suggest that future proposals should precisely specify the scope of the proposal and a detailed explanation of the rationale for adding each relevant asset class and type of security to the scope.

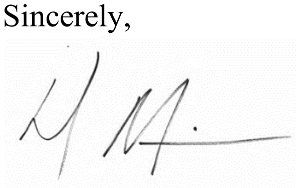
Notching

Given the concerns outlined above, we do not believe that the expansion of SVO's authority to notch NAIC Designations is currently appropriate. We believe that significant study should be conducted by the Task Force before considering granting any new notching authority to the SVO.

* * * * *

We appreciate the opportunity to comment on this proposal.

Sincerely,



Doug Niemann
Executive Vice President and Chief Risk Officer

[1] We believe revisions such as Subscript S should be discussed within the NAIC Capital Adequacy (E) Task Force, Macroprudential (E) Working Group, Life Actuarial (A) Task Force, and Statutory Accounting Principles (E) Working Group.

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June 29, 2023

The Valuation of Securities Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
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Re: Comments, Staff Proposal: Amendment to Update the Definition of an NAIC Designation in the Purposes and Procedures Manual of the NAIC Investment Analysis Office ("The Manual")

Dear Ms. Mears and Task Force Members,

What is conspicuously missing from the staff proposal is a clear and concise definition of NAIC Designations. This could be presented in a single paragraph or at most on one page. Decision-makers could benefit more from this than from seeing detailed implementation language.

Beginning with such a clear statement would be a sound practice for a number of reasons. The VOS/TF members themselves could evaluate a succinct proposal and decide if there is consensus among themselves about the definition. Then it could reach out to other affected parties, particularly the Capital Adequacy Task Force, to seek broader agreement or they could ask for a similar draft definition from them. When there is general agreement as to definitions then it would be time to direct staff to propose implementation language, such as modifications to manuals, and these drafts would then be examined to determine whether they conform to the agreed definition.

Having discussions, and agreement, on fundamentals at the outset, before drafting implementing documents, would be a sound decision-making practice.

The Need for Designations

The core function of the IAO is to produce risk factors, or Designations, for individual fixed income securities which meet the needs of its key constituent, the Capital Adequacy Task Force, which specifies and administers Risk-Based Capital calculation methods. The VOS/TF has additional functions, to be sure, but to fulfill its own central charge it must direct the IAO in its work as those staff members determine risk metrics on a security-by-security basis that meet the specific requirements for calculating RBC.

Because the CA/TF is responsible for making its own determination concerning what risk elements will be considered in deriving C-1 and R-1 RBC factors it is important to include it in the process at an early stage of deliberations. The VOS/TF has initiated this process so it is underway. The goal should be for the VOS/TF and the CA/TF, as well as others, to arrive at shared understandings of the risks reflected in Designations so they can all fulfill their individual charges.

Comments on the Staff Proposal Itself:

In addition to the foregoing, here are two specific comments, with recommendations, concerning the current version of this concept at the VOS/TF:

Development of the VOS/TF's Own Draft Definition

As the VOS/FT considers what risks to include in its proposal for a definition it should take into account existing work done to specify the individual risks of securities, of which credit is just one discrete element. A comprehensive report by the NAIC identified the eight risks to insurer of individual investments.*

This study is the result of considerable effort. While it or may not need to be updated, it is reasonable to expect that same amount of care and effort should be taken before modifying it as was taken in its development itself.

Once there is consensus as to a definition at the VOS/TF level as to a specific definition of Designations then it will be possible to reconcile that with proposals from other NAIC entities.

Evaluating the Full Range of Asset Risk Measures

Beyond just determining NAIC Designations, the IAO continues to serve as a window to the markets so the VOS/TF and insurance regulators can gain an enhanced awareness of developments therein. It can do this by continuing to consider how to develop statistics and risk measures for both individual assets and portfolios to fulfil its various charges. In this process it should work closely with regulators, particularly examiners, to assure that the tools it develops will be useful to them in their work. It should also balance the benefits it expects from this work with the costs of developing and maintaining them. Finally, it should not conflate these efforts with the completely separate charge discussed above of assuring that the IAO deliver the risk measures of individual assets to the specifications set by the Capital Adequacy Task Force for the computation of RBC.

Recommendation: Continue research and development work concerning investment risks

Enhancing the Usefulness of the S Subscript

As presently conceived the S subscript is intended to communicate "other non-payment risks". This subscript can potentially be useful, but it needs to be updated to reflect current developments. Credit risk is defined in Part One, ¶37, as "the relative financial capability of an obligor to make the payments contractually promised to a lender" and this is consistent with the findings of the IAWG subgroup. So if "credit risk" is the risk of non-payment how can there be "other non-payment risks" and what could they be? There are two logical possibilities.

The first reason for "non-payment" could be that the investor mistakenly believes that the borrower has made promises when, in fact, it has not. One example of this could be found in principal protected notes. These are actually debt-equity hybrid securities containing elements of each asset type. The only "bond-like" promise is for the return of principal at maturity. PPN investors need to understand that there are no representations of what their returns will be beyond the return of principal. These and many other security types have been addressed in "the bond project" and the results will be reflected in updated accounting guidance. In short, as in the example of PPNs, other assets not providing specific promises of returns will be denied bond status. Accordingly, there is no need to flag these with an S suffix as having "other non-

* Report of the Risk Subgroup of the Invested Asset Working Group (reporting to the VOSTF) August 6, 2008, Attachment two A-9, Minutes of the Valuation of Securities (E) Task Force, 12/06/2008 (submitted to you previously)

payment risks" because in those instances there is not an actual creditor relationship -- they are not eligible to be treated as bonds.

The other possible way there could be a risk of non-payment is that the rating/designation is simply wrong. By its very definition, credit risk is the risk of non-fulfillment of a *promise* to make certain payments. To be accurate and useful ratings/designations must take into account all significant reasons why promises by borrowers might not be kept. This is the very essence of credit ratings. Analysts, their supervisors and credit committees are accountable for taking into consideration relevant factors that could reasonably have adverse effects on a bond not delivering the promises set forth in its agreement with investors. Assuming rating agencies are performing properly then here, too, there is no role for the S subscript. If it is determined that rating agencies are not performing properly then corrective action must be taken.

So where and how can the subscript be useful to regulators? Here is one example. If in a specific case the S Suffix were used to denote limited liquidity of an asset then regulators could look at the totals of assets with limited liquidity and compare that to the liability posture of an insurer. This could be extremely helpful.

The S suffix doesn't presently indicate any specific reason for its assignment. Accordingly, regulators looking at statements with assets with S suffixes have no idea for the reason for the "S". It could be for liquidity but it could also be for any other number of reasons. This needs to be remedied.

Recommendation: Coordinate with the IAO to learn from regulators themselves which risk elements are of interest and concern to them, in addition to credit risk which is already the essence of a Designation. These other-than-credit risks would then each need to be assigned unique means of identification available to regulators in order for them to be useful.

Summary:

The most important point in this letter is that there is a need for relevant parties to agree on a short concise definition of NAIC Designations and this is primarily the responsibility of the CA/TF.

New risk metrics if justified and using the S suffix to specifically identify risks other than credit risk, would bring greater clarity and insights to insurance regulators. This would have the greatest potential if regulators themselves were actively engaged in developing these enhanced tools.

Christopher Anderson.

Copies: For the VOS/TF: Charles Therriault and Denise Genao-Rosado
Thomas Botsko, Chair, Capital Adequacy (E) Task Force
Philip Barlow, Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group
Dale Bruggeman, Chair, Statutory Accounting Principles (E) Working Group

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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

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

RE: Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the "P&P Manual") Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

DATE: April 25, 2023

Summary: At the Spring National meeting held on Mar. 23, 2023, during the discussion of the proposed amendment on Structured Equity and Funds, the Task Force directed the SVO staff to draft a distinct process on how it would recommend challenging an NAIC Designation assigned from a credit rating provider ("CRP") rating in the Filing Exemption ("FE") process which the SVO thinks is not a reasonable assessment of risk for regulatory purposes. The Task Force deferred action on the Structured Equity and Funds amendment pending its review of such a CRP ratings review process.

As noted in "Policies Applicable to the Filing Exemption (FE) Process" in P&P Manual, Part One, paragraph 80:

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

This amendment would grant the Securities Valuation Office staff some level of discretion over the FE process to address the NAIC's current blind reliance on credit ratings. It also addresses the Financial Condition (E) Committee's charge to the Task Force to:

> *Establish criteria to permit staff's discretion over the assignment of NAIC designations for securities subject to the FE process (the use of CRP ratings to determine an NAIC designation) to ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives.*

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

In the attached amendment the SVO is proposing a process by which it would be authorized to challenge an FE calculated NAIC Designation. The process would include steps such as the following:

- A means to identify to insurers a FE calculated NAIC Designation of concern via AVS+.
- Sufficient notice to allow an insurer to appeal/provide additional information before any action is taken.
- A formal review process by the SVO, with an opportunity for applicable insurance regulator(s) to consult on the deliberation, if they request.
- Establishment of the materiality threshold required to remove a CRP rating or security from FE eligibility.
- A means to either deactivate the notice of concern or revoke FE eligibility.
- If FE eligibility is revoked, provide notice that a full filing is required.
- A means to re-instate the CRP rating or security to FE eligibility should changing conditions or ratings warrant.

Recommendation: The SVO recommends adoption of this proposed amendment authorizing the procedures for the SVO's discretion over NAIC Designations assigned through the FE process. The proposed text changes to P&P Manual are shown below with additions in red underline, deletions in ~~red strikethrough~~ as it would appear in the 2022 P&P Manual format.

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

…

POLICIES APPLICABLE TO THE FILING EXEMPTION (FE) PROCESS

NOTE: The policies below provide the policy framework for "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three and are related to "The Use of Credit Ratings of NRSROs in NAIC Processes" discussed above; "NAIC Policy on the Use of Credit Ratings of NRSROs" and the "Definition – Credit Ratings Eligible for Translation to NAIC Designations" in Part Two ("Eligible NAIC CRP Credit Ratings" excludes the use of any credit rating assigned to a security type where the NAIC has determined that the security type is not eligible to be reported on Schedule D or the it is not appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of the security or asset.)

Determinations

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

Directives

81. The IAO shall:

- Recommend improvements to the production of NAIC Designations based on NRSRO credit ratings.
- Identify monitoring and communication procedures that enhance the possibility of regulatory intervention by the VOS/TF to respond to risks to insurer solvency posed by securities in the filing exempt population.
- Identify and develop correctives to the administrative, operational and system-based causes of reporting exemptions in the filing exempt process.

- Change the NAIC Designation equivalent calculated for filing exempt securities when necessary to correct errors or other anomaly that occur in the automated filing exempt process.
- Develop a staff-administered reporting exceptions resolution process that incorporates state insurance regulator and insurance companies' participation.
- In furtherance of the above directives, exclude specific otherwise Eligible NAIC CRP Credit Ratings or remove securities from the automated filing exemption process in accordance with the administrative procedures outlined in Part Two of this Manual, if the IAO, following a self or state regulator initiated review, determines the resulting NAIC Designation equivalent does not provide a reasonable assessment of risk for regulatory purposes.

…

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS
APPLICABLE TO THE SVO

…

SVO Administrative Symbols

153. SVO administrative symbols convey information about a security or an administrative procedure instead of an opinion of credit quality. The administrative symbols in use by the SVO and their meanings are described below.

SVO Analytical Department Symbols

154. All SVO analytical departments use the following administrative symbols:
…

- **REG** means that the NAIC Designation is under analytical review by direction of a state insurance regulator.
- **IAO** means the NAIC Designation is under analytical review initiated by the NAIC's Investment Analysis Office.

PROCESS FOR PLACING A FILING EXEMPT SECURITY UNDER ANALYTICAL REVIEW FOR POSSIBLE REMOVAL FROM FILING EXEMPTION

Overview

164. This section outlines the process by which a state insurance regulator or IAO staff can contest an NAIC Designation assigned through the filing exemption process which it thinks is not a reasonable assessment of risk of the security for regulatory purposes. Following a notice period and optional appeal by the insurer security owner, the Eligible NAIC CRP Credit Rating or the security's filing exemption eligibility could be maintained or revoked. If revoked, the insurer would then have the option of filing the security with the SVO for assignment of an NAIC Designation. An insurer can appeal revocation in subsequent filing years.

Notice Period

165. The IAO shall identify any filing exemption-eligible security assigned an NAIC Designation equivalent through the automated filing exemption process as being a "Filing Exempt Security Under Analytical Review" if: (i) a state insurance regulator notifies the IAO that it has determined the NAIC Designation equivalent is not a reasonable assessment of risk of the security for regulatory purposes and the IAO agrees with that determination, or (ii) the IAO, in its opinion, determines that the NAIC Designation equivalent is not a reasonable assessment of risk of the security for regulatory purposes.

166. The IAO will notify insurance company holders of a security determined to be a Filing Exempt Security Under Analytical Review by publishing on the NAIC's AVS+ product a separate SVO Administrative Symbol of either "REG", if the determination was initiated by a state insurance regulator, or "IAO", if that the determination was initiated by the IAO, each indicating that the IAO may block the use of the otherwise Eligible NAIC CRP Credit Rating or remove the security from filing exemption upon completion of its review. The IAO shall make a determination of the Eligible NAIC CRP Credit Rating or security filing exemption status within 120 days from initial notice or at the conclusion of any outstanding insurer appeal, whichever is later.

167. The IAO will post on the NAIC's AVS+ product a notice that the security is a Filing Exempt Security Under Analytical Review along with the initial date of the notice and the indicative NAIC Designation Category based on the IAO's preliminary assessment. The notice will remain open for a period of 120-days during which time an insurer that owns the security may, consistent with the VOS/TF policy Review of SVO Determinations, submit an appeal of the posted indicative NAIC Designation Category determined through the Materiality Threshold for IAO Analytical Review, described below, by following the operational steps outlined in the Appeals of SVO Determinations in this Manual.

168. The IAO will also provide a notification to insurance regulators that the security is a Filing Exempt Security Under Analytical Review along with the initial date of the notice and the indicative NAIC Designation Category based on the IAO's preliminary assessment. The notice will remain open for a period of 120-days during which time any insurance regulator that has a company that owns the security may discuss the security with the IAO and share their opinion as to its risk before the IAO makes a determination.

Materiality Threshold for IAO Analytical Review

169. When determining whether a security should be a Filing Exempt Security under Analytical Review, the IAO will consider the materiality of the difference between the Eligible NAIC CRP Credit Rating used in the filing exempt process and the IAO's own assessment of the risk. The IAO may elect to put a security under analytical review only if it determines, based upon its review, that the Eligible NAIC CRP Credit Rating is three (3) or more notches different than the IAO's assessment (e.g. NAIC Designation Category 1.G versus 2.C).

170. As part of its review, the IAO may consider observable factors such as (i) a comparison to peers rated by different CRPs, (ii) consistency of the security's yield at issuance or current market yield to securities with equivalently calculated NAIC Designations rated by different CRPs, (iii) the IAO's assessment of the security applying available methodologies, and (iv) any other factors it deems relevant. The IAO may request additional documentation and data, as necessary, to conduct its review.

Expiration of the Notice Period and Filing Exemption Determination

171. No later than 120 days after a security is marked as a Filing Exempt Security Under Analytical Review or following the conclusion of any outstanding appeal, whichever is later, the IAO Credit Committee, in its opinion and discretion, and in consultation with the applicable state insurance regulator(s), if requested, will make a final determination of whether the Eligible NAIC CRP Credit Rating or security should be removed from Filing Exemption eligibility.

172. If the IAO determines that the NAIC Designation Category assigned pursuant to the Filing Exemption process shall remain unchanged, the Eligible NAIC CRP Credit Rating or security shall remain eligible for Filing Exemption, the Filing Exempt Security Under Analytical Review notification will be deactivated and no further action will be taken at that time. The IAO's determination to maintain the filing exemption eligibility of an Eligible NAIC CRP Credit Rating or security shall not preclude the IAO from placing the same Eligible NAIC CRP Credit Rating or security under analytic review at a later date following a subsequent review should changing conditions warrant.

173. If the IAO determines the Eligible NAIC CRP Credit Rating or security should be removed from Filing Exemption eligibility, the IAO will add the Eligible NAIC CRP Credit Rating or security to NAIC systems with a notice to insurers that either the Eligible NAIC CRP Credit Rating or the security is not eligible for Filing Exemption and prevent it from utilizing the automated Filing Exempt Securities Process. An insurer that is concerned the IAO did not make its Filing Exemption determination regarding the insurer's security in accordance with the procedures in this Manual may request consideration of the concern by the VOS/TF pursuant to "Review of SVO Decisions by the VOS/TF" in this manual.

Assignment of NAIC Designation Category

174. For assignment of an NAIC Designation Category by the IAO to a security removed from Filing Exemption eligibility according to this section, the security would then need to be filed with the IAO according to the procedures outlined in this manual or through sufficient information having been submitted to the IAO through the Appeals of SVO Determinations, if there was one. If an Eligible NAIC CRP Rating has been removed from Filing Exemption eligibility according to this section and the security has another Eligible NAIC CRP Rating which has not been removed, then the security can receive its new NAIC Designation through the Filing Exemption process.

Reinstatement of Filing Exemption Eligibility

174. If an insurer would like the IAO to re-evaluate an Eligible NAIC CRP Credit Rating or security that was removed from Filing Exemption Eligibility for possible reinstatement in a subsequent filing year, it can follow the operational steps outlined in Appeals of SVO Determinations in this Manual to submit the request.

Reporting Securities Removed from Filing Exemption Eligibility

175. The Chair of the VOS/TF may request the IAO Director(s) to prepare a confidential, regulator-only report to be presented annually to the VOS/TF members, summarizing the Eligible NAIC CRP Credit Ratings and securities removed from Filing Exemption Eligibility over the prior calendar year and the reason for the removal.

…

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

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

Note: See "Use of Credit Ratings of NRSROs in NAIC Processes" and "Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force" (especially "NAIC Designations Do Not Communicate Statutory Accounting or Reporting" and "Policies Applicable to the Filing Exemption (FE) Process") in Part One; "NAIC Policy on the Use of Credit Ratings of NRSROs" (especially "Definition – Credit Ratings Eligible for Translation to NAIC Designations") in Part Two (the definition excludes the use of NAIC CRP credit ratings assigned to a security type where the NAIC has determined that the security type is not eligible to be reported on Schedule D or the it is not appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of the security or asset, as specified in this Manual); and "Filing Exemption Status of RMBS and CMBS" in Part Four (excluding RMBS and CMBS from the use of credit ratings for NAIC regulatory processes).

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 Deemed Ineligible for Filing Exemption at the Conclusion of the Process for Placing a Filing Exempt Security Under Analytical Review for Possible Removal from Filing Exemption in Part Two of this Manual –** For securities placed under analytic review by the IAO, if at the conclusion of the IAO Credit Committee's deliberation the IAO determines the security should remain eligible for Filing Exemption, the Filing Exempt Security Under Analytical Review notification will be deactivated and no further action taken will be taken. If the IAO determines the security should be removed from Filing Exemption eligibility, the IAO will add the security to NAIC systems with a notice to insurers that the security is not eligible for filing exemption and prevent it from utilizing the automated Filing Exempt Securities Process.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/Work-in-Progress/SVO Discretion/2023-xxx.01 P&P SVO Discretion.docx

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

July 25, 2023

The Honorable Rep. Warren Davidson
Member of Congress
2113 Rayburn House Office Building
Washington, DC 20515-3508

The Honorable Rep. Andy Barr
Member of Congress
2430 Rayburn House Office Building
Washington, DC 20515-1706

The Honorable Rep. Bill Posey
Member of Congress
2150 Rayburn House Office Building
Washington, DC 20515-0908

The Honorable Rep. Blaine Luetkemeyer
Member of Congress
2230 Rayburn House Office Building
Washington, DC 20515-2503

The Honorable Rep. Scott Fitzgerald
Member of Congress
1507 Longworth House Office Building
Washington, DC 20515-4905

The Honorable Rep. Andrew Garbarino
Member of Congress
2344 Rayburn House Office Building
Washington, DC 20515-3202

The Honorable Rep. Mike Flood
Member of Congress
343 Cannon House Office Building
Washington, DC 20515-2701

The Honorable Rep. Mike Lawler
Member of Congress
1013 Longworth House Office Building
Washington, DC 20515-3217

Dear Chairman Davidson and Representatives Barr, Posey, Luetkemeyer, Fitzgerald, Garbarino, Flood, and Lawler:

We appreciate the opportunity to clarify any confusion and address any concerns you have with the National Association of Insurance Commissioners' (NAIC)[1], ongoing efforts to improve state insurance regulation. We also appreciate your continued support for our national system of state-based regulation, which over the past 150 plus years has worked to ensure the solvency of the largest and most competitive insurance market in the world.

Before addressing the specifics of your inquiry, we want to provide some background on our regulatory approach to insurer investments and capital as well as changes that we are observing in insurer investment behavior, which helps put our current work in context. Insurers have invested more than $8 trillion in our economy and use those investments to support their obligations to

[1] As part of our state-based system of insurance regulation in the United States, the NAIC provides expertise, data, and analysis for insurance commissioners to effectively regulate the industry and protect consumers. The U.S. standard-setting organization is governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer reviews, and coordinate regulatory oversight. NAIC staff supports these efforts and represents the collective views of state regulators domestically and internationally. For more information, visit www.naic.org.

policyholders. The amount of risk-based capital they are required to hold, which directly impacts on their ability to pay claims, is linked to the risk of those investments. All insurer investments are given a "NAIC designation," which corresponds with a prescribed capital factor. If an investment is rated by one or more of the Nationally Recognized Statistical Ratings Organizations (NRSROs)—and roughly 80% of all insurer investments are rated—the NAIC designation is mapped directly to that rating with no further analysis or oversight by state regulators or the NAIC. These are called "filing exempt" or FE securities, in that they do not have to be filed with the NAIC's Securities Valuation Office (SVO) for review.

However, if an insurer chooses to invest in an unrated investment, the SVO provides centralized credit analysis for that security and produces the corresponding NAIC designation. This allows insurers the flexibility to go beyond traditional rated securities, while ensuring that the state regulatory system has confidence in the credit quality of those investments. Due to the vast scope of insurer investments, reliance on NRSROs provides an efficiency that we have no intention of displacing or competing with; however, because our risk-based capital system is linked directly to investment strength, this deference to NRSROs' opinions is not unconditional. It is also worth noting that the work the SVO performs on behalf of the states is for regulatory purposes only and is not released publicly or used to compete with NRSROs.

Insurers, and particularly life insurers, have long been relatively conservative, long-term investors to match the nature and duration of their long-term liabilities. However, a decade of historically low interest rates led to low yields on the traditional treasuries, municipal bonds, and high-quality corporate bonds the industry favored. This in turn compelled many insurers to seek higher yielding, but often more complex, less-liquid, and potentially riskier asset-backed securities, private placements, or other bespoke investments, which require consideration of whether a higher Risk-Based Capital (RBC) charge is appropriate due to increased risk.

In recent years, state regulators have noticed growing discrepancies between the ratings provided by competing NRSROs for the same security—in some cases, five or more notches difference in the ratings. Keeping in mind that the better the rating, the less capital an insurer is required to hold, the potential for "rating shopping" is a real concern and one with historical precedent. Indeed, because of such discrepancies for residential and commercial mortgage-backed securities, revealed during the Great Financial Crisis, we developed a separate credit analysis process for those securities that continues to this day.

In response to growing regulatory concerns with the financial engineering seen in bespoke investments today, the insurance commissioner members of the NAIC's Financial Condition (E) Committee's adopted a charge to:

Establish criteria to permit staff's discretion over the assignment of NAIC designations for securities subject to the FE process (the use of CRP ratings to determine an NAIC designation) to ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives.

In response to this direction from insurance commissioners on the Financial Condition (E) Committee, the NAIC Valuation of Securities Task Force (the "Task Force"), comprised of state insurance regulators, is now proposing to establish a process by which the SVO would be authorized to challenge the credit rating for a filing exempt security when certain conditions are met. The process, as it was exposed for public comment, would include the following steps:

- Establishment of a materiality threshold required to flag a CRP rating. To limit the SVO's use of this process to only that which would be considered truly material differences of opinion, the SVO would only be able to put a security or CRP rating on notice if it determines, based on the information at hand, that the CRP rating used in the FE process is three or more notches different than the SVO's assessment.
- A means to electronically identify to insurers an FE Designation of concern.
- Sufficient notice to allow an insurer to appeal/provide additional information before any action is taken. Insurers would have up to 120-days to appeal the SVO's assessment by introducing additional information and data, as necessary. This 120-day appeal period is similar to the existing appeal period for SVO assigned NAIC Designations.
- A formal review process by the SVO, with an opportunity for applicable insurance regulator(s) to consult on the deliberation, if they request.

These procedural steps ensure insurers are given due process: ample notification, an opportunity to appeal the SVO's initial assessment, an opportunity to get an alternate CRP rating, and sufficient time to file the security, if needed.

At the request of the Task Force Chair, the SVO would provide a report to a regulator-only meeting of the Task Force summarizing the eligible NAIC CRP credit ratings and securities removed from Filing Exemption Eligibility over the prior calendar year and the reason for the removal.

This proposal, as with all NAIC policy proposals, is subject to a transparent and deliberative public comment process that gathers and considers feedback from all interested parties. Interested parties have shared recommendations during the comment period that will be considered and incorporated if deemed appropriate by the Task Force.

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NAIC GOVERNMENT AFFAIRS

We believe the proposal, when adopted by our membership, is an appropriate approach to ensure that insurers are holding sufficient capital based on the risk they are taking with their investments and ultimately will leave policyholders better protected. We do not anticipate any competitive imbalance for NRSROs because our work is for regulatory purposes, to arrive at appropriate capital charges, and will not be released publicly or to the broader capital markets. The materiality thresholds we have put in place ensure that challenging a CRP will only commence when a significant red flag occurs, and even then, the notice and appeal process ensures fair treatment for all parties.

While we have no intention of challenging the NRSRO's methodologies or opinions or disrupting the important role they play in our public markets, we are also under no obligation to defer to them without judgment or exception as the de facto driver of our risk-based capital framework. Past financial crises and recent banking turmoil illustrate the importance of regulators ensuring that financial institutions' investments are suited to their customers' obligations, and accurately reflect the risks they choose to take.

We thank you for your interest in our work and your continued support for state-based regulation, and we are happy to provide more detailed briefings to you or any members of your staff on this important work.

Sincerely,

Chlora Lindley-Myers
NAIC President
Director
Missouri Department of Commerce and Insurance

Andrew N. Mais (He/Him/His)
NAIC President-Elect
Commissioner
Connecticut Insurance Department

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Jon Godfread
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Congress of the United States
House of Representatives
Washington, DC 20515

July 13, 2023

Chlora Lindley-Myers
President
National Association of Insurance Commissioners
444 North Capitol Street NW, Suite 700
Washington, D.C. 20001

Dear Director Lindley-Myers,

It has recently come to our attention that the Securities Valuation Office (SVO), comprised within the National Association of Insurance Commissioners (NAIC), published proposal to the Purposes and Procedures Manual (P&P Manual) that would significantly expand the NAICs discretion over filing-exempt securities.[1] The proposal has the potential to provides risk-based capital uncertainly for all filing exempt investments held by U.S. insurance companies (which includes thousands of CUSIPs), creating liquidity and market disruption. We write to urge you to withdraw the proposed changes to the P&P Manual.

The NAIC retains an essential role as both a unifying body for state regulators and as a standard-setter which ensures the U.S. insurance industry remains strong and robust across the 50 states, the District of Columbia, and five U.S. territories. In this role, the NAIC has held a particularly unique position amongst U.S. regulators for over 150 years. Much of our economic success can be attributed to the NAIC's steadfast mission to support state-based insurance regulation.

Despite the NAIC's successful track record, it was particularly concerning to see the proposal from the May 15th Valuation of Securities (E) Task Force meeting that would allow the SVO to review all filing exempt securities and contest nationally recognized statistical rating organizations (NRSRO) NRSRO ratings if it believes a rating "is not a reasonable assessment of risk of the security for regulatory purposes."[2] Such discretion, which appears to lack any formal methodology, if enacted, would deviate significantly from the NAIC's proper role within insurance regulation. We fear that such discretion would make NAIC regulated entities susceptible to staff-driven agendas.

Additionally, these same proposals could undermine a competitive market amongst NRSROs and exacerbate the SVO's recent gravitation towards becoming an unregulated NRSRO competitor.

While we are aware the SVO has significantly grown its operations and revenue in recent years despite its limited size, the recent proposals would expand the SVO's footprint well-beyond that of a regulator. Should these proposals get enacted, the SVO would become an unregulated, de facto NRSRO and undermine market competition through their unfair competitive advantage.

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[1] Nat'l Ass'n of Ins. Commissioners, Valuation of Securities (E) Task Force Meeting, May 15, 2023, https://content.naic.org/sites/default/files/call_materials/VOSTF%20Materials%202023-05-15%20v1.pdf (discussing the Proposed P&P Manual amendment authorizing the procedures for the SVO's discretion over NAIC designations assigned through the filing exemption process.)

[2] *Id.*

This unfair competitive advantage would arise from a conflict of interest within the SVO where the SVO would both set fees and designate securities. Using the NAIC's unique position to steer business through its commercial services, while simultaneously incentivizing U.S. insurers to stop using private sector ratings firms, would be an unwelcome paradigm shift.

The state-based regulatory framework continues to be a time-tested model of success. We cannot risk upending this framework by opening the door to SVO staff-driven actions that could ultimately hurt competition, imperil the capital adequacy of NAIC regulated entities, and make it harder for insurer's ability to meet their obligations. We ask that the NAIC withdraw the recent proposals and work to ensure the SVO does not undermine the integrity of our state-based regulatory structure or interfere with competition amongst NRSROs.

Please reach out to my office if you would like to discuss further.

Sincerely,

Warren Davidson
Member of Congress

Andy Barr
Member of Congress

Bill Posey
Member of Congress

Blaine Luetkemeyer
Member of Congress

Scott Fitzgerald
Member of Congress

Andrew Garbarino
Member of Congress

Mike Flood
Member of Congress

Mike Lawler
Member of Congress

Mike Monahan
Senior Director, Accounting Policy
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July 14, 2023

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

Re: Practices & Procedures (P&P) Manual Amendment Authorizing the Procedures for the Securities Valuation Office's (SVO's) Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears:

The undersigned (ACLI, PPIA, NASVA, SFA, MBA, and CREFC) appreciate the opportunity to comment on the exposure referred to above that was released for comment by the VOSTF on May 15, 2023. We generally like to provide constructive comments on VOSTF exposures and provide support wherever possible. Regarding this exposure, the undersigned have concerns with the proposal and believe additional transparency is warranted. We also recommend changes that are necessary to avoid significant unintended consequences.

Prelude

As discussed at the NAIC Spring National meeting, the undersigned recognize that VOSTF seeks additional information on certain types of insurer investments, with the SVO acting as the "eyes and ears" for Regulators. Further, we recognize that some Regulators may want to grant the SVO some latitude in challenging rating agency ratings if they are deemed not fit for NAIC purposes ("not fit for purpose"). The undersigned stated at the NAIC Spring National meeting, and this was further supported by Texas Regulator, Jamie Walker, that full transparency is warranted for both the NAIC (including the SVO) and the insurance industry, but that is not present in this proposal.

The undersigned appreciate the opportunity to comment and would like to highlight some significant, specific concerns with the exposure. In recent years, the NAIC has made several changes to increase reporting regarding insurer investments, including requiring rating rationale reports as part of the filing exemption (FE) process. As outlined in greater detail below we recommend that any additional changes to the FE process first identify specific ways that NRSRO methodologies are not fit for purpose for a given asset. We also recommend that the NAIC/SVO be transparent about their specific concerns that would warrant such significant changes. Given the magnitude of the potential impacts of this exposure, we also recommend that Regulators convene to study the issue in depth like the study commissioned by the VOSTF in 2008 (referred to in our Subscript S letter dated June 29, 2023). In the interest of providing constructive feedback, the undersigned outline additional transparency and oversight measures below that can mitigate our concerns and help minimize downstream impacts of the proposed exposure. The undersigned believe it is in the best interest of all parties – Regulators, NAIC staff, insurance companies, rating agencies, and capital markets participants – to have complete procedural transparency.

Concerns

1) The exposure currently places the right to challenge a rating or methodology, and the ability to make a final decision on such rating or methodology, solely with NAIC staff and potentially with just one regulator. There is no requirement for oversight from VOSTF, or another sub-group of regulators, to ensure consistency of process or to provide an independent view, should NAIC staff and insurers disagree. This poses due process problems, as well as potential extra-territorial application of one state regulator's decision over insurers domiciled in other states.

2) In the exposure a ratings challenge from NAIC staff starts with staff's view on a designation, having only had access to the Credit Rating Provider (CRP) rating and rationale and to Schedule D information. NAIC staff would lack access to critical information provided in a full security filing when they first determine their proposed designation. Practically speaking, the insurer would then need to informally file the security for a more thorough review from NAIC staff, should the insurer wish to engage in a fully informed dialogue about the security with the SVO or SSG. The exposure treats this subsequent filing and dialogue as a ratings appeal, rather than recognizing that NAIC Designation filings and appeals are separate processes.

3) Should the VOSTF proceed with this proposal, the undersigned believe that there must be a separate appeal process in place, with oversight from an independent party, to ensure due process for insurers. The exposure provides limited transparency to insurers (and to their capital markets counterparties) regarding the SVO's/SSG's rationale supporting a CRP ratings challenge. The only envisaged disclosure is for a challenged rating to be flagged in the NAIC Automated Valuation Service (AVS+). However, there is no requirement for NAIC staff to provide public disclosure regarding why they are uncomfortable with a rating. Instead, such information can only be obtained with a phone call between the filing insurer and the SVO analyst. This is problematic, because other insurers who hold the same security (and other interested capital markets participants) may not be privy to some of the one-off, undocumented discussions. Lack of consistent, public disclosure of the NAIC's concerns leaves room for guessing and misinformation within the capital markets. This could result in market uncertainty and increased illiquidity. The current exposure has already had a negative effect on capital markets. Several transactions have been put on hold, as insurance company investors are sidelined from certain investments, due to the lack of transparency in the current exposure. To date, NAIC staff has provided only limited examples of types of transactions they are concerned about. The lack of further clarity regarding NAIC staff's scope and method of review has created risk-based capital uncertainty for portfolio investments (both current and future). Insurers have a strong need to understand what the NAIC's concerns are with a given rating—especially when NAIC staff are deeming a rating methodology as unfit for regulatory purposes.

4) The exposure does not require staff to publicly report aggregate statistics for ratings challenges. Staff are only required to provide an annual report at VOSTF's request, and even then, such a report would not be shared publicly.

Collectively, the issues highlighted above serve to create a process that, if implemented, would lack transparency, sufficient checks and balances, and the opportunity for insurers (and ratings agencies) to present their data, information, and ratings rationales in a fair, open forum. For example, assume there is an Asset-Backed Security (ABS) where the rating agency rating assumes 10% appreciation in the underlying collateral, but the SVO assumes 0% appreciation and believes their approach is more fit for purpose. The proposed exposure, where any single security rating is challenged based on a methodology concern, would cause several significant problems:

a. One state, working with the SVO, could dictate NAIC Designations for companies in other states where the same security is held.
b. Further, such a security would not be in isolation. The ratings challenge would presumably apply to all similarly situated, rated securities. The challenge would create significant market uncertainty, as it would be unclear to industry and interested parties whether the SVO's concern applied to just:
   i. One CRP's rating methodology, or other CRPs' methodologies as well (i.e., other rating agency methodologies may also assume collateral appreciation, but at different levels).
   ii. That particular legal structure or type of ABS,
   iii. A subset of that particular ABS type,
   iv. A specific, unique structural feature or anomaly in that ABS, specifically (or that would also potentially apply to other ABS as well), or
   v. A general matter of difference in professional judgment of the particular analyst.

Changing any particular security rating within AVS+ would create problems and would not achieve the stated goals of consistency, uniformity, and appropriateness necessary to achieve the NAIC's financial solvency objectives. Ultimately, this would create significant capital markets disruption. The undersigned would like to recommend some changes that we believe would help strike the right balance between the NAIC's need for ratings oversight and with industry's and capital markets' need for transparency and due process.

Suggested Changes to Improve Transparency

Should the VOSTF choose to proceed, we believe a robust and transparent process is warranted. The process should make clear whether a rating is challenged due to (1) a CRP's rating methodology being deemed unfit for purpose, or (2) as a matter of professional judgment (we believe the latter would be relatively rare). The SVO should publicly identify rating agency methodologies that they do not believe are fit for the NAIC's purpose and provide analytical support for such view on each respective CRP methodology in question. Whenever the SVO challenges a rating based on differences in professional judgment, it should provide insight on its own approach for assigning a designation to that security. More specifically, the undersigned's proposed solution includes the following:

1) Whenever a CRP rating is challenged in AVS+, not only should the security's rating be flagged, but there should also be an area in the system that provides a written rationale for why the rating is being challenged. The AVS+ system should include a field that carries a single category description for ease of use in future reporting (e.g., methodology not fit for NAIC purposes, or professional judgment). However, that alone is not a sufficiently transparent explanation. There should also be an attached report or link to a publicly available rationale where the SVO analyst highlights:

   a. Key factors considered in the SVO analysis, and the methodology utilized;
   b. A rationale as to why the CRP's methodology is not fit for purpose (if applicable) or where the SVO analyst's view differs materially from the CRP (if a difference in professional judgment), and
   c. The scope of the population of securities for which the change applies.

2) When NAIC staff challenges a CRP methodology as being unfit for purpose, these challenges should be disclosed publicly and brought to the VOSTF for approval prior to any ratings change. This should include the rating methodology or methodologies (if multiple rating agencies) deemed not fit for purpose, along with a robust rationale, as well as what securities are impacted. Impacted insurers and the relevant CRPs can then present their analyses, including relevant data and security information, models (if applicable) and rationale publicly to VOSTF, and VOSTF can serve as the ultimate arbiter after hearing views from both sides. Benefits of a public discussion include:
   a. Prevents one regulator and the SVO from unilaterally making regulatory decisions that potentially impact other state regulators, other insurers, and other similar securities;
   b. Provides transparency to the Capital Adequacy Task Force (CATF), as it is CATF's responsibility to determine appropriate RBC charges and model factors;
   c. Ensures all enacted changes are in line with the stated goals of consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives;
   d. Aligns the VOSTF's stated goal of engaging further with the CRPs as a consumer of ratings to gain a better understanding of their process, methodologies, and regulatory oversight.
   e. Provides appropriate checks and balances, affording due process for insurers and transparency to all stakeholders.

3) In the case of differences in professional judgment (which we believe would be relatively rare, especially considering the proposed three-notch threshold for a ratings challenge), the SVO/SSG should be required to perform a full security filing review and disclose to the insurers the SVO's or SSG's own applicable methodology, laying out the key considerations and rationale that NAIC staff considers for similar securities.

   If the SVO and impacted insurers are unable to reach agreement on an appropriate designation during the initial challenge process, then it is important for the insurer to have some method of appeal beyond NAIC staff to provide appropriate independent review and ensure consistency to the designation process. The undersigned would not expect insurers to appeal every ratings challenge (nor would it be practical for VOSTF to hear to every such appeal), but there are expected to be key instances where insurers feel strongly that an additional third-party's viewpoint (beyond the SVO/SSG and the original CRP) is needed and helpful. Ultimately, such discussions may help Regulators as well, as it would help them develop a deeper understanding of how investments are viewed by insurers, capital markets participants, and the rating agencies, as well as by the SVO. More discussion is merited on whether the appropriate appeals board should be the VOSTF or some subset thereof. However, the appeals process should include people who are willing to independently consider all views, and who can set policy across all states consistently.

4) As a best practice, all SVO designation methodologies, and a description of the NAIC's process of reviewing and approving these methodologies, should be posted publicly on the NAIC's website. We recognize that the SVO and SSG will not have models or methodologies covering the full bond population. Indeed, no CRP can rate the full bond population, given the sophisticated data gathering, modeling, analytical software and other resources required to rate certain types of securities. However, posting methodologies publicly would highlight areas where the SVO/SSG do not have designation methodologies in place, such as ABS or (currently) Collateralized Loan Obligations (CLOs), and help ensure that those methodologies which do exist are consistently applied, providing transparency to insurers and to capital markets.

5) The undersigned believe industry should be provided with an overall assessment of how this ratings challenge program progresses and is enforced. Aggregated statistics, shared publicly each quarter, would help both Regulators and industry alike to understand the scope of the issues and how the program is progressing. NAIC staff should provide quarterly reports for both VOSTF and the public, highlighting the following for securities challenged:

    a. Number of ratings challenged, for each challenge type;
    b. Number and dollar-amount of CUSIPs challenged;
    c. Outcome of SVO/SSG challenges:
        i. Percentage of CRP ratings affirmed vs. percentage of SVO designation overrides;
        ii. Number of challenges appealed to VOSTF and percentage of appeals where NAIC staff's recommendation to overturn a rating the was affirmed by Regulators vs. percentage of appeals where the original CRP ratings were affirmed;
    d. Average number of notches that ratings were reduced, both on an incident- and dollar-weighted basis.

Further Considerations

The undersigned suspect one concern VOSTF may have with our proposal centers around confidentiality associated with private ratings. However, we think confidentiality concerns are manageable. Federal law requires that NRSROs disclose and maintain their methodologies publicly, and rating methodologies can be found directly on CRP websites. Any questions on such methodologies can be answered through discussions with CRP analysts. Therefore, for situations where NAIC staff is challenging a methodology as not fit for purpose, staff should be able to discuss the methodology that the CRP employed and discuss where the NAIC takes issue with that methodology, without disclosing non-public information. When NAIC staff is challenging a rating based on differences in professional opinion, the underlying CRP rating can be expressed in terms of an NAIC-equivalent designation (as opposed to disclosing the CRP rating directly), and the details of the issuer or structure can be genericized enough to mask the specific security, yet still provide key insights into the reason and rationale for ratings challenges. In fact, the SVO has successfully done this with some limited examples in the past.

The only downside the undersigned see in such approach is additional effort required of the SVO/SSG, but the benefits are many. Enhanced transparency is generally good for any system, but here, it is imperative for insurers to understand what types of investments or ratings methodologies concern the NAIC to limit negative downstream consequences for insurers. This also is necessary to limit capital markets disruption and prevent both investment bankers and insurers from arbitrarily rejecting established private placement debt types as a viable option for insurers' portfolios. Absent more transparency, the market could potentially deem the entire privately-rated debt universe as problematic when Regulators and the SVO have only expressed concerns with a targeted subset of that universe. Insurers need to understand what is and is not problematic, and why, as well as how, the SVO or SSG might view certain types of securities. Further, without transparency, the public debt market (particularly the 144A space) could also experience significant disruption, which could cause unnecessary negative impacts to insurers' investments in such instruments. Any reasonable cost associated with providing transparency and oversight, as outlined in our solution above, would be supported by industry. It is likely minimal in relation to the significant benefits that transparency affords to all stakeholders.

Conclusion

The undersigned stand ready to discuss these ideas further with Regulators and with the SVO/SSG; we are willing to begin discussions immediately. We ask that adoption of the exposure be postponed until the significant philosophical and procedural issues highlighted above can be resolved.

Given the magnitude of this proposed change, and the potential effect on insurers and capital markets, the undersigned believe that this process may be best suited for a comprehensive study by Regulators across disciplines. A working group could be established with members from the NAIC's CATF, Risk-based Capital Investment Risk and Evaluation Working Group, Life Actuarial Task Force, and VOSTF, to holistically address what we understand the broader regulatory concern to be: Whether the NAIC investment risk-based capital regime has kept pace with market innovation. This approach could be patterned after the previously mentioned study commissioned by the VOSTF in 2008 that met extensively over an approximately eight-month time period to define and evaluate perceived shortcomings and issue a formal report. In this instance, a report should have specific recommendations that address defined problems holistically and transparently. The following are some of the issues that the working group could consider:

- Define areas of concern raised by the SVO and by some Regulators with as much precision as possible to properly scope the project;
- Identify whether there are any investment types with significantly different risk characteristics which may warrant additional investment RBC factors (as was suggested by Moody's Analytics at the time of development of current investment RBC factors);
- Identify additional asset classes, if any, where modeling may be appropriate, such as with CLOs; and
- Evaluate any input from the VOSTF Ad Hoc Rating Agency Review group.

Lastly, we also think it is important to recognize that credit analysis is both an art and a science; differences of professional opinion are unavoidable. No one organization (whether an insurer, a CRP or the SVO/SSG) has a monopoly on perfect accuracy when assessing risk. An institution's ability to assess credit risk will inevitably be shaped by unique organizational experiences, risk tolerances, and resources or tools brought to bear in the risk assessment process. Furthermore, each CRP (and NAIC staff) has certain areas of relative strength and expertise and areas where their resourcing and expertise is weaker. Therefore, in addition to defining the concerns with as much precision as possible at the outset, ongoing transparency is key to any process. Industry is, and has been, committed to transparency, as evidenced by our willingness to submit ratings rationale reports and provide transaction documents upon NAIC staff's request. We ask for the same level of transparency from the NAIC.

The current exposure grants the SVO significant unilateral powers, with very little transparency, and without sufficient due process or checks and balances. This proposal, if adopted, would be materially disruptive to the insurance industry. Rather, the undersigned propose that the identified concerns with reliance on CRP ratings be addressed in a holistic way, backed by disciplined and rigorous analysis, with output that is transparent to all parties. This would address Regulator concerns without creating undue market disruption and the other shortcomings that the undersigned have identified in this letter.

The undersigned stand ready to assist in this process in a meaningful way, but we believe that is best done transparently and through collaboration. We believe Regulators understand the importance of transparency and would like to achieve a transparent outcome as well. We appreciate the opportunity to participate in this ongoing process.

Sincerely,

	Tracey Lindsey	*John Petchler*
Mike Monahan ACLI	Tracey Lindsey NASVA	John Petchler on behalf of PPiA Board of Directors
Lisa Pendergast CRE Finance Council	Michael Bright SFA	Mike Flood Mortgage Bankers Association

cc: Charles Therriault, Director, Securities Valuation Office
Eric Kolchinsky, Director, Structured Securities Group

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

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

The Private Placement Investors Association ("PPiA") is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PPiA serves 66 member companies and works with regulators, NASVA, the ACLI, the American College of Investment Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace. For more information, visit www.usppia.com.

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

The Structured Finance Association is the leading securitization trade association representing over 370 member companies from all sectors of the securitization market. Our core mission is to support a robust and liquid securitization market and help its members and public policymakers grow credit availability and the real economy in a responsible manner. SFA provides an inclusive forum for securitization professionals to collaborate and, as industry leaders, drive necessary changes, advocate for the securitization community, share best practices and innovative ideas, and offers professional development for industry members through conferences and other programs. For more information, visit www.structuredfinance.org.

MBA is a national association representing the real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets. Its membership of more than 2,200 companies includes all elements of real estate finance: independent mortgage banks, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies, credit unions, and others in the mortgage lending field.

CREFC comprises over 400 institutional members representing U.S. commercial and multifamily real estate investors, lenders, and service providers – a market with over $5 trillion of commercial real estate ("CRE") debt outstanding. Our principal functions include setting market standards, supporting CRE-related debt liquidity, facilitating the free and open flow of market information, and education at all levels. One of our core missions is to foster the efficient and sustainable operation of CRE securitizations. To this end, we have worked closely with policymakers to educate and inform legislative and regulatory actions to help optimize market standards and regulations.

The Lease-Backed Securities Working Group

July 14, 2023

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

Re: P&P Manual Amendment Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears:

Our group, *The Lease-Backed Securities Working Group*, appreciates the opportunity to comment on the proposed amendments to the P&P Manual described above. We have a number of concerns about the proposal, which we discuss below, but we also want to suggest several ways in which the proposal could be improved to mitigate some of those concerns.

Primarily, we do not believe that this policy -- which permits the IAO to selectively review and overturn NRSRO ratings of individual securities -- could be implemented without causing massive disruption in the capital markets. For markets to function, investors need to have confidence *when purchasing a security* that they can accurately anticipate the risk factors -- and the related capital charges -- associated with that purchase. For insurance companies, this predictability is currently achieved through the Filing Exemption process, which insures that all bonds with the exception of structured securities (CLOs, CMBS and RMBS) are "*entitled to a presumption of convertibility to **the equivalent NAIC designation***" (P&P Manual, Section 2). *Any* uncertainty associated with the assignment of risk-based capital charges is bound to put a damper on markets.

This uncertainty is aggravated by the observation by market participants that SVO-assigned designations historically have varied widely -- even among securities with similar characteristics -- and likewise bear no fixed relation to NRSRO ratings, even as they are consistently more conservative. Investors will inevitably perceive that downgrades are likely but that -- in the absence of any methodologies from the SVO -- that the magnitude of those downgrades is largely unpredictable. Worse, this policy will have the effect of handcuffing insurance companies, who will be the only market participants subject to this additional uncertainty and will put them at a competitive disadvantage in the market relative to non-insurance company investors who will not be subject to the same uncertainty and who may confidently rely on the ratings provided by the NRSRO with respect to a given issue.

It should be made clear to regulators that the new proposed language is not a minor change but is instead a major expansion of the authority of the SVO. If a bond is eligible for Filing Exemption, nothing in the current P&P Manual gives the NAIC the power to pick and choose between NAIC-approved Credit Rating Providers ("CRPs") or reject an individual rating by an NAIC-approved CRP.

Under the definition of "*Credit Ratings Eligible for Translation to NAIC Designations*", the current P&P Manual clearly states that *any* credit rating of a security provided by a Credit Ratings Provider with NAIC-approved status for that activity and market "by application of its long-term ratings scale and methodology" (and monitored annually, etc.) "*is entitled to a presumption of convertibility to **the equivalent NAIC designation**".* (P&P Manual, Part 2)

Elsewhere in the Manual, there is a confusing definition that purports to be a definition of "Eligible CRP Credit Ratings" but is in fact a clarification of which securities are eligible for Filing Exemption:

> *"**Eligible NAIC CRP Credit Ratings**" excludes the use of any credit rating assigned to a security type where the NAIC has determined that the security type is not eligible to be reported on Schedule D or that it is not appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of the security or asset);*

The first clause of this sentence simply clarifies that Filing Exemption does not apply to non-Schedule D securities. The second clause permits the SVO to determine, *with regard to a specific security or asset*, that it is not appropriate for "NRSRO credit ratings" (i.e.: Filing Exemption) to be used to determine the regulatory treatment of *[that] security or asset* (although no justification is required for making that determination regarding a given security). That is to say, that a specific security so-designated by the SVO is not eligible for Filing Exemption by *any CRP* and must be filed with the SVO.

However, as stated above, nothing in the current P&P Manual gives the NAIC the power to pick and choose between NAIC-approved CRPs or reject an individual rating by any approved CRP of an otherwise-eligible security. If the current proposed new language is adopted, these sections of the Manual will also have to be rewritten to make it clear that the SVO has been given this new authority to selectively accept or reject individual CRP ratings at its sole discretion. ***This discretion will seriously erode the predictability of the current system which the insurance industry relies on in making investment decisions.***

The proposed new language states that the IAO would be authorized to remove securities from the automatic filing exemption process if it determines that the resulting NAIC designation "does not provide a reasonable assessment of risk *for regulatory purposes*." Presumably those regulatory purposes could only be insuring the solvency of the regulated companies, and we are not aware of any risk other than credit risk which is part of an NAIC Designation[1].

The SVO has identified a small number of securities (43 in total) where its opinion of credit quality differed significantly from the rating provided by the respective CRP -- although without citing any specific flaws in the CRP ratings, or providing its own independent ratings analysis of

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[1] * The P&P Manual explicitly states that:

"**NAIC Designations express opinions about credit risk** -- defined as the relative financial capability of an obligor to make the payments contractually promised to a lender." [and that] NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk."

each security. Moreover, our group has not seen any evidence presented that the scale of the problem would justify the potential harm that could be done to capital markets, or that the small number of securities so far identified rises to the level of materiality for capital adequacy or creates solvency concerns for any specific company or group of companies.

Given the potential for significant market disruption, we would suggest an alternative approach focused on specific situations where the issue rises to the level of materiality. This would be to have the SVO/IAO first identify any insurance company with a sufficient number of investments with "questionable" CRP ratings to present possible solvency concerns for the regulators. This information could then be presented to the appropriate regulator or State Commissioner, with suggestions for further action, which could include a more in-depth analysis of that company's investment portfolio. This could be done confidentially without causing major market disruption, and could include the involvement of the NAIC's Financial Analysis Working Group.

This more focused and risk-based approach would be a significantly more efficient use of the SVO's limited staff and resources. It is also consistent with the stated goal of having a 'targeted' approach, and would be less disruptive to markets than having the SVO conduct a review the CRP ratings of thousands of securities -- a "shotgun" process which by its very nature would put a chill on markets.

Finally, any policy to question and potentially overturn CRP credit ratings needs to keep in mind a basic principal, which is that, in advance, there is no such thing as a "correct" credit rating: all opinions about credit risk are just that: opinions. They are predictions about what may or may not happen in the future -- and as Yogi Berra once famously remarked, "Predictions are hard to make; especially about the future."

This being the case, any policy which is finally adopted needs to adhere to certain guidelines:

1.) Any review of an NAIC-approved CRP credit rating needs to be based on a thorough and detailed analysis by the IAO of the specific credit, presented to the investor in a ratings-report format comparable to the ratings rationales required by the SEC of all Nationally Recognized Statistical Ratings Organization. Just as with the NRSROs, that report needs to specify exactly what rating methodologies were used and highlight the specific data and/or conclusions in the CRP report which the IAO disagrees with.
2.) The appeal process needs to be shortened [one to two months at most] and would commence only once the IAO has submitted its full ratings rationale to the investor.
3.) There needs to be an independent third party, *not the IAO itself*, which adjudicates any disagreement about which credit opinion is more valid.
4.) The burden of proof should be on the IAO to refute the credit opinion of the CRP -- by citing specific omissions or conclusions of the CRP -- not on the investor to defend the CRP rating.

Any policy which does not include these basic guidelines will put a serious damper on the capital markets and subject insurance companies to handicaps not faced by other investors, placing them at a serious competitive disadvantage in the marketplace.

The company portfolio-focused approach we propose is practical and implementable and offers specific advantages to regulators and insurers alike while minimizing the downside risks. However, given the potential for significant capital markets disruption, **we hope that the Task Force would agree that the proposed amendments to the P&P Manual warrant much more study and consideration before any policy is implemented.**

Finally, we believe that it is essential that any policy that is ultimately approved -- either based on the language in the current exposure, or modeled on the process we suggest -- be automatically monitored no later than six-months to a year after implementation to be reassessed for its effectiveness, its impact on the insurance industry and the capital markets, and to determine a cost-benefit analysis before making it a permanent policy.

Sincerely,

JMGarrison

John Garrison
On behalf of:
The Lease-Backed Securities Working Group

Copies: Charles Therriault and Denise Genao-Rosado

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July 13, 2023

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

Re: Comments, Staff Proposal: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "P&P Manual") Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears and Task Force Members,

This letter focuses on the governance aspects of the captioned proposal.

Included here are very detailed steps that this task force can take to 1) improve the transparency and functionality of the proposal and 2) enhance its ability to oversee the IAO/SVO if it decides to grant staff the significant new powers it seeks.

How the VOS/TF Could Oversee the IAO/SVO With Respect to This Proposal

Here are six specific elements of a proposal that would facilitate the ability of the VOS/TF oversee the IAO/SVO:

1) <u>Prior to commencing investigations, the IAO/SVO could be required to consult with the VOS/TF or its delegates and obtain its approval for conducting inquiries</u>. The nature of these approvals should be entirely within the jurisdiction of the VOS/TF and could be as broad or limited, as sweeping or specific as the task force judges prudent. This would not necessarily limit "fishing expeditions" by the staff but those would require "fishing licenses" issued by the VOSTF. This would be of significant benefit to the task force because rather than *perhaps* receiving general "summary" reports once a year (on request), the VOS/TF would have real time knowledge of the activities of its staff. This also allows the VOS/TF to "keep score" of how its staff is performing with "hits and misses" on more of a real time basis.

2) <u>The VOSTF could review the methods to be used by the IAO/SVO to determine the "materiality thresholds for analytical review"</u> (¶169 & 170) to assess their validity in judging whether a three notch difference is probable.

3) <u>The VOS/TF could assist the IAO/SVO in gaining access to information it would require to conduct its investigations.</u> Because the NAIC itself is not a regulatory body, the IAO/SVO lacks

the authority to direct insurers to deliver information to it, even if needed to perform its duties. The VOS/TF could accomplish this by requesting that regulators instruct their regulated insurers to provide information about specific securities. By requesting this information the VOS/TF would then have an oversight obligation to assure that IAO/SVO staff members are not improperly using material non-public information delivered to them but this could be managed as is done by NRSROs.

4) The VOS/TF or its designees could specify the periodicity and detail level of reports it requires from the IAO/SVO.

5) The VOS/TF could require that the findings for any investigation by staff meet reasonable standards of justification. In all probability this means that the staff must replicate the work of the rating agency in order to properly evaluate all of the credit positive and credit negative elements of the security so as to be able to determine whether it agrees with the work of the rating agency. If the IAO/SVO is proposing to override rating agency ratings then its work product should be at least to the rating agency standards. Reports by staff should be submitted in the same detail and to the same standards as for "rating rationales" prepared by rating agencies. This explicitly requires the disclosure of specific rating methodologies and explanations of how those have been applied.

6) The VOS/TF could develop a review or appeal process, accessible to insurers, to make it more transparent and accountable than is currently proposed. By monitoring the results of these appeals the task force would gain key insights into the performance of the IAO/SVO.

Delegation of Authority, Not Responsibility

There should be no doubt as to who is responsible for overseeing the conduct and performance of the IAO/SVO[1]. These employees are delegated a great deal of legally enforceable power but they are not directly subject to the control of any actual governmental body. Authority is granted to staff by the VOS/TF when it approves the manual for the IAO/SVO. This delegation of power is, in turn, authorized at higher levels by the Financial Condition (E) Committee and ultimately by the NAIC's Plenary as those entities approve of the work of this task force and other NAIC entities.

One of the first things I learned as a young infantry officer is that while authority can be delegated, as is proposed here, responsibility cannot be. By this principle, the responsibility for the conduct and performance of the IAO/SVO to act according to its manual of instructions continues to rest with the entities that grant those powers. The VOS/TF is at the first level of responsibility for oversight. NAIC management certainly has administrative control over its staff in many respects but when it comes to the execution of its duties specified in its manual then continued responsibility rests with the entity that confers those powers -- this task force.

[1] "2023 Adopted Charges The Valuation (E) [*sic*] Securities (E) Task Force will: 1) Review and monitor the operations of the NAIC Securities Valuation Office (SVO) and the NAIC Structured Securities Group (SSG) to ensure they continue to reflect regulatory objectives…." https://content.naic.org/cmte_e_vos.htm

Overseeing the IAO/SVO with Respect to this Proposal

In the past the VOS/TF appointed a special entity to assist it in fulfilling its responsibility of overseeing the SVO. That was the SVO Oversight Working Group and it was directly accountable to the task force itself. Today nearly half of all NAIC members sit on the task force, but it is a very unusual position of having no working or study groups reporting to it. This contrasts with prior years where there were as many as three supporting entities.

As to oversight, the staff proposal contains a single provision:

> ¶175. The Chair of the VOS/TF may request the IAO Director(s) to prepare a confidential, regulator-only report to be presented annually to the VOS/TF members, summarizing the Eligible NAIC CRP Credit Ratings and securities removed from Filing Exemption Eligibility over the prior calendar year and the reason for the removal.

This provision does not even begin to approach acceptable levels of governance given the significant additional powers staff is requesting. It is even startling because while it says the VOS/TF *may* make requests it does not require the Directors to actually do anything. This is analogous to employees telling their managers that management *may* ask for a summary of activities once a year. Clearly this version of the staff proposal does not contemplate any significant level of oversight.

Fortunately it is not the staff that decides how its work is to be overseen. For the staff the manual is its basis for authority and it is both limiting and binding. That same manual certainly does not and cannot constrain or limit the oversight activities of the VOS/TF. The task force is free to provide for more specific and detailed accountability.

A Precedent for Gaining Information Concerning Performance

In the past the SEC confronted a situation similar to what the VOS/TF faces today. In that instance the SEC needed to determine how the public could gain insights concerning the conduct and performance of rating agencies. Now the question faced by the VOS/TF is how it can gain sufficient insights to fulfill its oversight responsibilities. The actions taken by the SEC can provide a template for the NAIC as they essentially answer the same question.

After the public outcry and severe criticism of their Nationally Recognized Statistical Ratings Organizations during and after the financial crisis of 2007 –'08 the SEC acted forcefully. Prior to that time it is my understanding that NRSROs were granted "no action letters" to recognize their status but there was not much more to it than that. The SEC reacted to the crisis by imposing significant requirements in order to fulfil its mission to "….protect investors and ensure the integrity of the rating process, including through the office's oversight of Nationally Recognized Statistical Rating Organizations[2]" These include, among many other requirements:

- Mandating the public disclosure of rating methodologies

[2] https://www.sec.gov/news/press-release/2023-21

- Requiring the preparation of rating rationales explaining how the methodologies were applied for each rating
- Conducting examinations to determine whether NRSROs were complying with their published procedures
- Specifying that rating agencies can only act as NRSROs for assets in the five asset classes for which they were specifically registered with the SEC and
- Publishing a report each year which "…summarizes the findings from our annual examinations and also provides information about NRSROs, their credit ratings businesses, and the industry more broadly."

The SEC also requires each NRSRO to publish on its websites standardized information in what is called the "Form NRSRO". The form includes these exhibits:

- Performance Measurement Statistics
- Procedures and Methodologies Used to Determine Credit Ratings
- Policies and Procedures to Prevent the Misuse of Material Nonpublic Information
- Organizational Structure
- Code of Ethics
- Conflicts of Interest Related to the Issuance of Credit Ratings
- Policies and Procedures to Manage Conflicts of Interest
- Information Regarding Credit Analysts and Credit Analyst Supervisors and
- Information Regarding Designated Compliance Officer

In short, these are just some of the steps SEC has taken to provide information to members of the public with the goal of allowing them to develop informed opinions of rating agency performance so they would not have to rely blindly on the NRSROs.

The VOS/TF can use these same tools now to meet its oversight obligations. This precedent shows in specific concrete terms, what it takes to understand the performance of a rating agency. The SEC's purpose was to inform the public. The VOS/TF's need now is to inform itself.

How to Move Forward

Concerning this staff proposal that it be granted significant new power, it is not very likely that this 26-member VOS/TF, with its existing resources and acting by itself as an undivided whole, will be able to effectively oversee the IAO/SVO. Here are some things that can be done to accomplish that --

Specific Recommendations:

<u>Reappoint a working group to oversee the performance of the IAO/SVO</u>. That working group would have appropriate charges and report to the VOS/TF

<u>Reappoint a second working group to consider and prioritize efforts concerning existing and developing investment risks</u>. Previously such a group was called the Invested Asset Working Group. Hopefully this would eliminate some of the pressure on the VOS/FT to create *ad hoc* groups in the future

Retain outside professional, independent, investment risk expertise. Obviously this is essential to create a meaningful appeal process that is a part of this proposal.

One Additional Possibility -- Time for a Ground-Up Reappraisal to Reimagine How the NAIC Can Meet the Needs of Regulators Examining Insurer Investments

Given the potential difficulty of overseeing staff activities in the existing structure perhaps it is time to reconsider whether there are better ways the NAIC can meet the needs of regulators than it has been using for past decades.

This is not unprecedented. In the past the NAIC has retained outside consultants to advise on how best to evaluate insurer assets. Long ago the NAIC retained KPMG Peat Marwick which prepared 35-page report[3] on the performance of the SVO. That report was not released to the public but those task force members who have never seen it could benefit from reviewing it and considering the ideas for improvements it contains. A more recent study by Oliver Wyman was also not released but that, too, may contain useful information and ideas.

So there have been two extensive studies in the last 25 years, but the most recent one I know of was done years ago. Given that, it may well be time now to commission a new, independent and comprehensive review.

There should be no preconceived notions. It may or may not be that the bond-by-bond analysis process that has been in place for decades now can be improved upon. Rather than seeking minor fixes or incremental improvements perhaps it is time to consider whether it would be beneficial to build new capabilities from scratch to best meet the needs of today and the future.

This task force alone cannot commission such a sweeping review but it certainly can recommend and provide justification for it.

Summary

The proposal could be revised, as suggested, to improve its processes and transparency. This would have the added benefit of giving the VOS/TF greater insight into staff activities and would improve the accountability of the staff to the task force. Governance and oversight could also be improved by requiring the compilation and release of information similar to what the SEC requires of the rating agencies it regulates, also as specified above.

Hopefully even as these steps could improve governance they might also have the benefit of reducing reduce the likelihood and perhaps the severity of possible market disruptions. Given the extent of the powers being proposed this is not an idle fear. To paraphrase a paper published by the NAIC and jointly edited by a then past president and later CEO of the NAIC, “when the insurance regulators sneeze the markets can catch a cold”.[4] Ideally, with oversight and transparency, it might be possible to prevent even sniffles.

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[3] “Report on Due Diligence Practices and Procedures of the Securities Valuation Office” June 1998

[4] Finnerty, J, Kwan, M, (2007) When the Insurance Regulators Sneeze , The Hybrid Market Can Catch a Col*d, Journal of Financial Regulation*, NAIC 6

It may also be time for the NAIC to conduct a bottom-up review of what regulators actually need as they review the investments of insurers and how the NAIC can meet those needs, putting everything on the table to seek the best result.

Copies: For the VOS/TF: Charles Therriault and Denise Genao-Rosado

This is in furtherance to the discussions held on this topic at the VOSTF meeting held on Monday, May 15, 2023.

I am Marty Carus, President of Martin Carus Consulting LLC, I have been working in the insurance industry since 1965, first as a regulator for 34 years and as Chief Examiner with the New York Insurance Department (now merged into the New York Department of Financial Services). As a regulator, I heavily participated in NAIC activities and chaired or co-chaired the VOSTF (as well as several other NAIC groups) on several occasions. Subsequently, I worked 15 years for a major insurer group and represented that group at several NAIC meetings as well as at the IAIS. I now am a consultant but I am expressing the following comments as a consumer/policyholder of various and several insurance products, an investor in insurance companies as well as other entities that either themselves invest in insurers or are to a degree reliant on insurance to conduct their businesses and last but not least of all, as a taxpayer. I note that this proposal, like almost all other NAIC proposals, does not in any way define its associated costs which are substantial and are ultimately borne by either policyholders as any of such regulatory costs are passed along through premiums or annuity considerations; or by investors since such costs not ultimately borne by consumers, lower income of insurers and thus adversely impact their capital suppliers either through lower dividends or lower performance which translates into lower stock prices and thus lower rewards for capital suppliers. These deleterious impacts could be offset by benefits to the named constituencies; however, the proposal includes no calculation, nor even an estimate, of any benefits associated with the proposal. How can that be? If an insurance entity operated that way it is likely that regulators would be aghast at such poor business practices and poor enterprise risk management procedures. Moreover, as a taxpayer, I am aghast that the governments I pay for operate in such a manner. Noting that any benefit from a new regulatory procedure can be cast as protecting consumers from operational harm, I also note that there is no *estimate,* at least, of any specific quantifiable enhancement of the solvency oversight function conducted by regulators. At least, with such a calculation of benefit, one could compare that with the dollar cost of the new proposal to determine whether the proposal, or any proposal, is worth the cost net, of course, of the protections afforded policyholders, beneficiaries and claimants through guaranty funds. As a member of each of the constituencies noted above, I would expect that be the pro forma operational paradigm for crafting proposals, especially this specific one. Perhaps you can answer why this wasn't done in this instance or is not the general procedure of the NAIC.

It is well established that the staff of the investment arms of the NAIC has not been fond (to put it mildly) of the Filing Exempt ("FE") process put into effect decades ago. It seems to me that this is a first attempt to overturn a process that has worked extremely efficiently and at low cost for decades. Also, there has not been a major market participant that has encountered a severe adverse market event/insolvency in decades and I cannot remember any insurer's risk-based capital being materially understated due to its investment operations. It seems there was a single instance of a company, a minor market player indeed, having gone under but there was massive fraud involved in that situation. (Note: I define a major market participant as an insurer with even as much as 1% market share but I firmly believe you could reduce that considerably below even 1% and the results would be the same.)

This leads to the following questions:

1. Why is this proposal being made at this time if at all?
2. Why is there no materiality threshold included in the proposal?
3. What specific conditions have arisen that suddenly make this proposal necessary?
4. Has the insurance industry experienced a financial strength decline due to its investment operations outside of the normal investment market variations that result from cyclical overall economic conditions?
5. Are there examples of companies abusing the FE process to the extent that its RBC calculations were materially misstated to somewhat hide an adverse financial condition requiring regulatory intervention?
6. Is the current solvency regulatory regime "good enough as is?"

What are the answers to these questions?

Perhaps most notably, nothing in the proposal indicates any consideration of possible unintended consequences which could arise from implementing this proposal. Insurers conduct their investment operations needing at least some semblance of regulatory certainty on a time-sensitive basis. Making investment decisions are not open-ended as to timing. They employ, in the aggregate, thousands of investment professionals to engage in investments operations or rely on outside sources which employ such professionals. They also interact, closely with regard to private placements, with rating agencies which, in turn employ thousands of credentialed investment professionals. Thus, the FE process allows companies to be able to determine the regulatory capital needed to support its investments *at the time decision-making for an investment has to be made*. Retrospective Monday morning quarterbacking second guessing investment decisions can make for severe market dislocations and cause insurers to shy away from making *appropriate risk-weighted investment decisions* in fear of having their decisions being arbitrarily overridden by an almost non-existent staff at the NAIC employing non-transparent procedures. As a consumer trying to be prudent in choosing companies to which I wish to do business with, or as an investor choosing which insurer to invest in, am I supposed to rely on a small staff of people unfamiliar and perhaps uncredentialed to deal with complex investments or rely on companies having much larger professional staffs and possessing a track record of *proven* performance. From past experience when there have been dislocations of the investment market due to regulatory miscalculations (e.g., relative to “debt/equity hybrids” and “trust preferreds” where bond treatment was disallowed severely disrupting the market and then subsequently reversed due to the widespread recognition of the unintended consequences of the initial decisions), I don’t see the case for regulatory meddling with the current system which has been shown to have worked just fine. In short, the proposal seems to represent a solution to a non-apparent, non-defined problem. If a single investment’s rating for RBC purposes seems awry but is immaterial as to an entity’s overall RBC, so what?

Before continuing to incur cost and until a solid case can be made on a cost/benefit basis and in consideration of answers to the questions included above herein, this proposal should be withdrawn.

Marty Carus
President of Martin Carus Consulting LLC

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July 13, 2023

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

Re: Practices & Procedures (P&P) Manual Amendment Authorizing the Procedures for the Securities Valuation Office's (SVO's) Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears:

Thank you for the opportunity to comment on the above-referenced exposure. While we appreciate the potential issues the SVO wishes to address through the proposed amendment, we have some concerns which we discuss in this letter.

The proposed language provides the SVO with the means and processes to take actions that we believe will benefit policyholders in the long run. Nevertheless, the proposed framing and implementation of these processes leave us with concerns relating to process transparency, industry interaction with the SVO and sufficiency of SVO resources, and potential disruption to industry deal flow.

We have summarized below our concerns with the proposed framework and process and provide recommendations that we believe will enhance the SVO's role in working with industry participants around these issues.

Concerns

A ratings challenge from the NAIC staff may be based on only the limited information provided by the CRP. The lack of more extensive material that the insurer might provide to the SVO in an initial filing could result in ratings changes or challenges based on incomplete information.

Without disclosure of the SVO's reasoning behind a changed rating, investors may not be able to understand the SVO's specific exceptions to the CRP rating or methodology in question. This could lead to investor and issuer uncertainty and could result in a negative effect on market issuance.

Investors understand that it is of paramount importance that the SVO have the resources necessary to undertake the processes proposed. To the extent the SVO lacks such resources, investors want to have confidence they could look to the NAIC to address SVO needs.

Genworth

Potential solutions

Transparency and fulsome disclosure from the SVO as to its judgment around CRP ratings would address concerns regarding investor knowledge and market uncertainty.

The SVO should publicly identify rating agency methodologies with which they have an issue and describe in detail the basis for any challenge. Similarly, the SVO should lay out the rationale for its designation of a security whose rating it is changing.

As part of this process, and in order to reduce designation uncertainty over time, the SVO should be available for direct discussion of its analysis and conclusions with interested members of industry.

VOSTF could ensure the SVO has adequate resources to carry out the processes envisioned by requiring any challenges to a CRP methodology and any proposed ratings changes to be presented to VOSTF for approval.

Thank you for your time and attention to this matter. Please feel to contact Michael Shepherd at michael.shepherd@genworth.com or (203) 708-3324 with any questions or comments.

Very truly yours,

Genworth Financial, Inc.

By: Kelly S
Kelly A. Saltzgaber
EVP and Chief Investment Officer

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July 13, 2023

Carrie Mears, Chair
Valuation of Securities (E) Task Force
National Association of Insurance Commissioners
c/o Charles Terriault and Denise Genao
Via Email: ctherriault@naic.org and dgenao1@naic.org

RE: Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* ("the P&P Manual") Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears,

Thank you for the opportunity to comment on the Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* ("the P&P Manual") Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process (Exposure), which is intended to provide the Valuation of Securities Task Force ("VOS/TF") with better visibility into the methodology and impact of both public and private credit ratings as well as the ability to change the filing exempt (FE) designation if deemed appropriate. The following is submitted on behalf of the member companies of the National Association of Mutual Insurance Companies (NAMIC).

NAMIC has more than 1,500-member companies representing 40 percent of the total U.S. property/casualty insurance market. NAMIC member companies serve more than 170 million policyholders and write more than $323 billion in annual premiums. Our members' direct written premiums account for 67 percent of homeowners' insurance and 55 percent of automobile insurance. Through NAMIC advocacy programs it promotes public policy solutions that benefit NAMIC member companies and the policyholders they serve and fosters greater understanding and recognition of the unique alignment of interests between management and policyholders of mutual companies.

NAMIC appreciates the SVO's goal of ensuring greater consistency, uniformity, and appropriateness to achieve appropriate financial solvency objectives and balancing that goal against the risk of blind reliance on credit ratings. However, NAMIC has some concerns surrounding the processes as listed in the Exposure.

Transparency in reasoning, standards, and the materiality threshold would allow companies to know why securities are flagged and the three-notch difference between the Eligible NAIC CRP Credit Rating and the Insurance Analysis Office's (IAO) assessment. The Exposure provides limited insight into the process; it is unclear why a security would be placed under analytical review of IAO or if there are asset classes that will typically be flagged. Paragraphs 169-170 of the Exposure give some observable factors but there is still little knowledge of the IAO's process. What are the materiality threshold references in the Exposure and are there certain characteristics that would flag one FE security for review over another? The Exposure states that the IAO may ask for additional data and documentation may be requested to conduct the review. Are there examples of said data and documentation that can be provided? Will there be any fees associated with this IAO review?

The Exposure states that the IAO may deem an entire security class ineligible for the filing exemption designation, but it does not provide any metrics or standards for doing so. If an entire security class is deemed ineligible for filing exemption, the IAO should publish its reasoning in addition to giving timely and prompt notice to insurers. It is unclear if there will be an appeal process or a dialogue for a class determination or if the appeal process only exists at the individual insurance company level.

In addition, there is uncertainty around the appeal process. As the Exposure is written, VOS/TF would have the ability to change a FE rating for any reason and there is not a clear review path. For example, what types of materials would need to be presented for the review? How would an insurance company request an appeal and is the appeal with the IAO staff or the relevant regulator? What is the time frame from revocation of the FE eligibility to providing a full filing of the security? How do other rating agencies opinions on a security, if any, weigh into the IAO process?

The P&P Manual is currently incredibly long and represents the documentation of a very complicated process, built up over the years, to serve both regulators and industry. While NAMIC does understand the VOS's duty to provide information to the regulators' regulating financial solvency and is supportive of that goal, the current Exposure has too much uncertainty and lacks transparency. NAMIC appreciates the benefit of a shared understanding of standards, thresholds, and process between supervisors/regulators and the industry and NAMIC looks forward to the continuing dialogue.

www.namic.org

Thank you,

Colleen W. Scheele, Public Policy Counsel and Director of Financial and Tax Policy
National Association of Mutual Insurance Companies

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July 13, 2023

Ms. Carrie Mears, Chair
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1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197
Via email: ctherriault@naic.org and dgenaorosado@naic.org

Re: P&P Manual Amendment Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears,

As the market leader for Kroll and Egan-Jones rated debt issuances for financial institutions, we wanted to inform you that the current NAIC proposals have already caused a major market disruption as word of the pending proposals permeate all levels of the insurance industry. As a result, an increasing number of insurance companies have instituted a moratorium on purchasing all Kroll and Egan-Jones rated transactions in these markets. Prior to buying a particular transaction, insurance companies need to know what the NAIC designation will be in order to monitor their regulatory capital charges. By keeping these insurance companies on the sidelines, they have now been put at an enormous disadvantage versus the entire institutional investor universe. Additionally, this has materially impaired capital markets access for a multitude of high quality, small to mid-sized issuers spanning the financial institutions marketplace given the absence of insurance company investors.

Since 2014, there have been approximately 438 Kroll and Egan-Jones Rated Regional and Community Bank debt transactions totaling $29.9 Billion[1] and 114 Kroll and Egan-Jones Rated Non-Bank Financial debt transactions totaling $8.9 Billion[2] covering REIT, insurance, asset manager, broker-dealer, specialty finance and other real estate related companies in both the public and private debt capital markets. The emergence of the Kroll and Egan-Jones bond rating agencies has been critical in helping to establish this burgeoning national corporate debt market following the Great Financial Crisis. These transactions have been sound investments for the insurance companies enabling them to earn strong risk-adjusted returns.

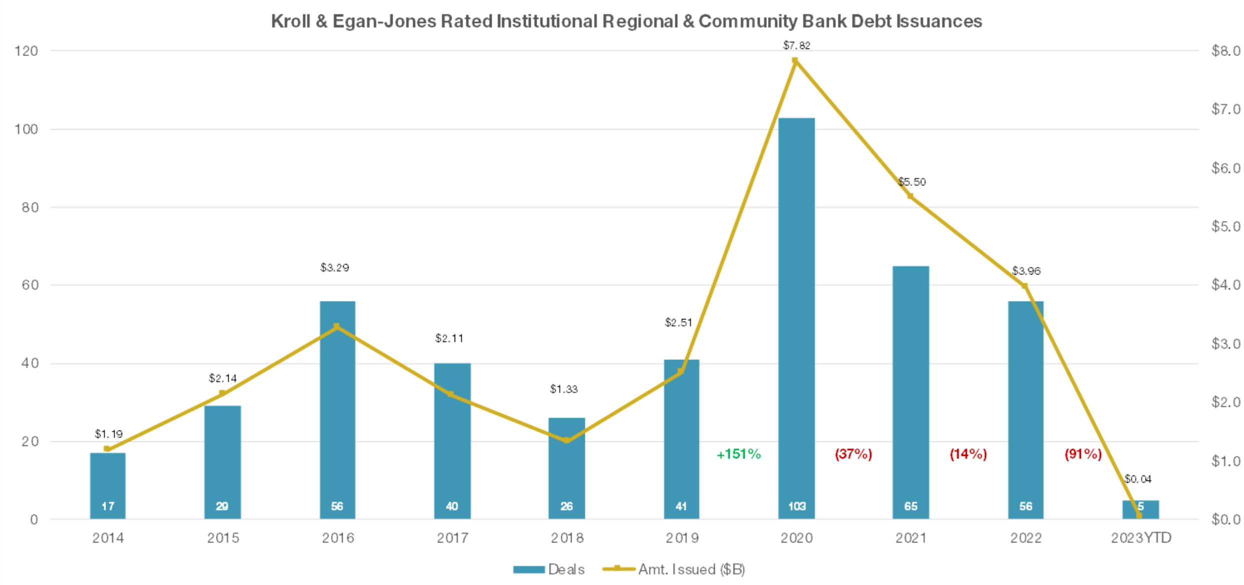
In 2020/2021, when the onset of COVID-19 shut down the credit markets for a period of time, Kroll and Egan-Jones rated institutional bank and non-bank transactions grew to record high volumes following the Federal Reserve's implementation of multiple national stimulus packages. Beginning in 2022, the market for Kroll and Egan-Jones rated bank and non-bank financial debt started to significantly drop off in both total number of deals and respective transaction sizes. This was partially due to deteriorating market conditions, however, the NAIC's negative bias towards the smaller rating agencies also materially impacted insurance investors' willingness to invest in bank and non-bank financial debt transactions. As an increasing number of insurance company investors have learned of the proposed NAIC/SVO's intent to unilaterally assign high credit risk designations to Filing-Exempt securities, the market has come to a virtual halt, denying many strong and viable companies the ability to raise capital. Furthermore, this action, if ever implemented, would immediately cause affected securities to lose value and cause mark-to-market losses for all insurance companies and severely harm the U.S. insurance industry.

[1] Includes both Piper Sandler and all Wall Street underwriters
[2] Total represents only Piper Sandler issuances

Kroll & Egan-Jones Corporate Bond Volumes

Kroll & Egan-Jones Rated Institutional Regional & Community Bank Debt Issuances

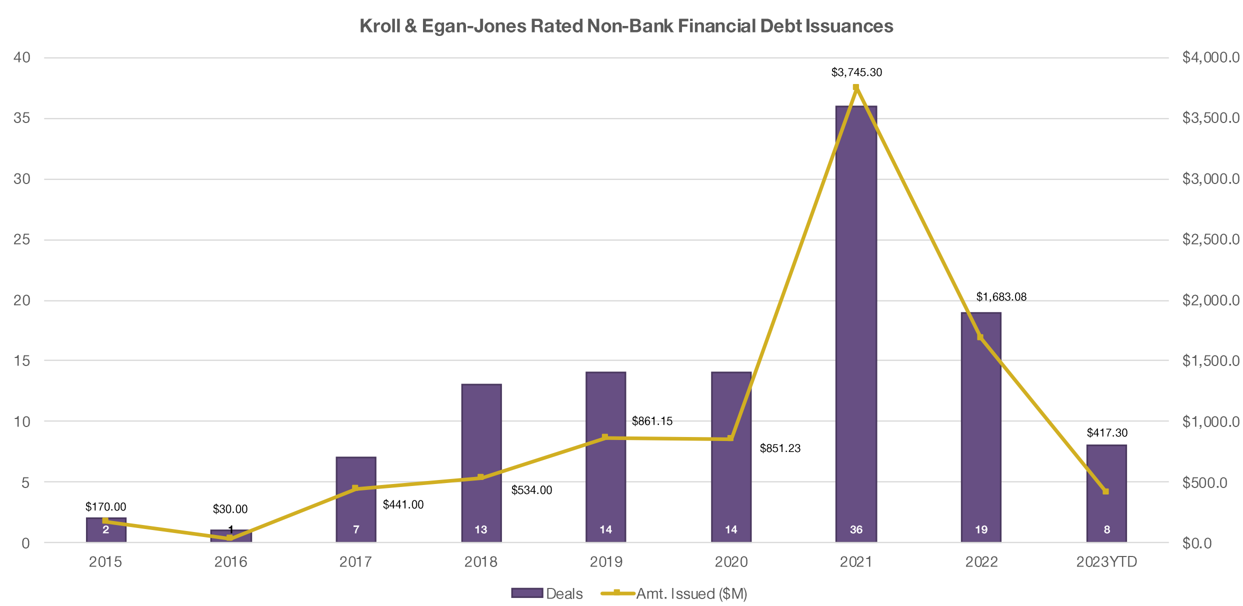
2014 – 2023YTD: 438 Deals for $29.9 Billion



Note: Deal count includes $1000 par subordinated debt and senior note offerings for Community Banks; Community Banks defined as banks or bank holding companies with less than $65 billion in assets rated by Kroll and/or Egan-Jones; Deal count does not include offerings for Community Banks with over $65 billion in assets at the time for the transaction; Excludes transactions less than $5 million in offering size
Source: S&P Global Market Intelligence, Bloomberg, Piper Sandler Syndicate Desk

Piper Sandler Kroll & Egan-Jones Rated Non-Bank Financial Debt Issuances

2015 – 2023YTD: 114 Deals for $8.87 Billion



Source: S&P Global Market Intelligence, Bloomberg, Piper Sandler Syndicate Desk

It should be noted that of the 552 financial services transactions depicted above, only one issuer has gone into default (First NBC Bank Holding Co. which issued $59.3mm of Kroll-rated BBB- subordinated notes in 2017). This implies an extremely low default rate of only 0.18%. By contrast, SVB Financial (Moody's: Baa1 / S&P: BBB-), Signature Bank (Moody's: Baa2 / Fitch: BBB) and First Republic Bank (Moody's: Baa1 / S&P: A- / Fitch: A-) all failed this spring and each of the three banks were rated by Moody's, S&P and/or Fitch.

We, similar to many market participants, do not believe the NAIC / SVO has the required resources, analytical capability or regulatory status (i.e., not an SEC regulated NRSRO) to unilaterally implement unexpectedly high credit risk designations to select transactions without the necessary transparency or rationale. Since this market was initiated in 2014, our insurance clients have always carried out intense due diligence on all corporate credits that have successfully come to market. Both Kroll and Egan-Jones, as SEC regulated NRSROs, allocate exhaustive resources and manpower to analyze these issuers and carry out multiple phone calls to directly interact with the respective management teams. The credits are monitored throughout the year and through the annual surveillance process the ratings are affirmed with updated rating reports that include a ratings rationale. Both Kroll and Egan-Jones have developed long tenured and proven rating methodologies, all of which are furnished to the NAIC/SVO via their stability and transition reports.

The other important development in this market that has come to be of immense value to our insurance company buyers is the number and frequency of acquisitions that have occurred over the years resulting in substantial upgrades in many instances. We have witnessed more than 50 mergers and acquisition transactions involving our Kroll and Egan-Jones rated issuers which have resulted in many issuers being acquired by much larger corporations that have had ratings from the largest rating agencies. The increased value of their acquired investments boosts the performance and credit quality of their overall investment portfolios. The issuers in our space tend to be smaller and more niche oriented within their industries, which leads to a higher probability for merger and acquisition activity which in turn has improved credit quality and stronger ratings. In fact, just this month we have witnessed the most recent example of this trend in the REIT sector as Ellington Financial (EJR: A) has announced a merger with Great Ajax Corp (EJR: BBB), which will result in a much larger, more highly rated security for the holders of Great Ajax's $110mm 8.875% senior notes that were issued in August 2022.

In conclusion, since the Great Financial Crisis this active corner of the corporate debt market has enabled hundreds of corporations to successfully raise attractive financing while effectively serving the investment portfolio needs of the U.S. insurance industry. Both Kroll and Egan-Jones have successfully fulfilled their mission as well-respected SEC regulated NRSROs in providing ratings to this sector of the financial services industry. The fact that the number of defaults or impairments have been negligible only supports insurance investors' view of the important role that these rating agencies play in the debt capital markets. Investors greatly benefit from enhanced competition and methodological differentiation amongst what is a finite group of SEC regulated NRSROs. As long as these new proposals hang over the marketplace, the ability of these smaller corporations to raise capital and provide strong, value-added investments for the insurance industry will be irrevocably harmed.

I am available to discuss at your convenience and can be reached at: +1 (203) 861-7643 or email: jacques.desaintphalle@psc.com.

Sincerely,

Jacques de Saint Phalle
Piper Sandler & Co.
Head of Debt Capital Markets/Syndicate

Jacques de Saint Phalle is the head of the Fixed Income Capital Markets and Syndicate Group at Piper Sandler. Previously, he was a principal of Sandler O'Neill + Partners, L.P. where he focused on executing fixed income and private equity capital raises for financial institutions. He has formed deep and extensive relationships with investors in his 38 years of capital markets experience. Prior to joining Sandler O'Neill in 2007, de Saint Phalle was a managing director in the structured finance group at FTN Financial and before that, fixed-income syndicate manager at Keefe, Bruyette & Woods, Inc. He was one of the key senior executives hired to help rebuild KBW after the firm suffered significant losses in the terrorist attacks of September 11, 2001. Prior to KBW, de Saint Phalle was global syndicate manager of Bear Stearns' fixed income corporate bond department. He joined Bankers Trust in 1993 to build its corporate bond unit. In 1989 he established the corporate bond department at Citicorp after the Federal Reserve granted securities underwriting powers to the U.S. money center banks. de Saint Phalle spent three years at Rensselaer Polytechnic Institute and holds a bachelor's degree from the University of Wisconsin-Madison. He played Division 1 hockey at both institutions and was a member of Wisconsin's NCAA Division I Championship team in 1983.

TIAA

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Filed via Electronic Mail

June 22, 2023

Carrie Mears
NAIC Valuation of Securities Task Force

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Through the Filing Exemption Process

Dear Ms. Mears:

Teachers Insurance and Annuity Association of America ("TIAA") appreciates the opportunity to provide comments on the Valuation of Securities Task Force's proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* ("P&P Manual") regarding the procedures for the Security Valuation Office's ("SVO") discretion over the National Association of Insurance Commissioners ("NAIC") designations assigned through the filing exemption ("FE") process. Following the NAIC's Spring National meeting, the Valuation of Securities Task Force ("Task Force") requested that the SVO staff develop a process to challenge a NAIC Designation assigned from a credit rating provider ("CRP") in the FE process that the SVO does not consider to be a reasonable assessment of risk for regulatory purposes. We understand that the stated purpose of the proposed amendment is to grant the SVO discretion over the assignment of NAIC designations for securities subject to the FE process to ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives. Although we appreciate the objective and purpose, TIAA has concerns with regard to two of the proposed updates, which we believe are problematic for the entire industry. We discuss our concerns below.

I. **About TIAA**.

Founded in 1918, TIAA is the leading provider of retirement services for those in the not-for-profit space including the academic, research, medical, and cultural fields. Over our century-long history, TIAA's mission has always been to aid and strengthen the institutions, retirement plan participants, and retail customers we serve and to provide financial products that meet their needs. With our strong not-for-profit heritage, we remain committed to the mission we embarked on in 1918 of serving the financial needs of those who serve the greater good.

To carry out this mission, we have evolved to include a range of financial services, including asset management services offered by our subsidiaries. TIAA has $1.3 trillion in assets under management, and our investment model and long-term approach aim to benefit the 5 million retirement plan participants we serve across more than 15,000 institutions.[1]

II. **The proposed amendment would provide the SVO with authority that would have unintended consequences.**

As stated above, TIAA understands the intent of the proposed amendment to grant the SVO discretion over the assignment of NAIC designations for securities subject to the FE process. The proposed amendment sets forth criteria that would authorize the SVO to challenge an FE calculated NAIC designation. The proposed criteria includes:

- Providing insurers a means to identify an FE calculated NAIC Designation of concern via AVS+.
- Providing sufficient notice to allow an insurer to appeal/provide additional information before any action is taken.
- The development of a formal review process by the SVO, with an opportunity for applicable insurance regulator(s) to consult on the deliberation of the designation, if they request.
- The establishment of a materiality threshold required to remove a CRP rating or security from FE eligibility.
- Developing a means to either deactivate the notice of concern or revoke FE eligibility.
- Providing notice that a full filing is required if FE eligibility is revoked.
- Providing a means to re-instate the CRP rating or security to FE eligibility should changing conditions or ratings warrant reinstatement.

In formulating our comments, TIAA has carefully considered the exposure draft and its implications. Overall, our concerns are focused on proposed Sections 81 and 170, which we believe are problematic for the entire industry:

1. **Section 81 is amended to include the following provision:**

"In furtherance of the above directives, exclude specific otherwise Eligible NAIC CRP Credit Ratings or remove securities from the automated filing exemption process in accordance with the administrative procedures outlined in Part Two of this Manual, if the Investment Analysis Office ("IAO"), following a self or state regulator initiated review, determines the resulting NAIC Designation equivalent does not provide a reasonable assessment of risk for regulatory purposes."

[1] As of June 30, 2021

2. **<u>Section 170 is amended to add the following language to the P&P Manual:</u>**

"As part of its review, the IAO may consider observable factors such as (i) a comparison to peers rated by different CRPs, (ii) consistency of the security's yield at issuance or current market yield to securities with equivalently calculated NAIC Designations rated by different CRPs, (iii) the IAO's assessment of the security applying available methodologies, and (iv) any other factors it deems relevant. The IAO may request additional documentation and data, as necessary, to conduct its review."

TIAA is concerned that these sections provide the SVO with the authority to override the rating of any FE security for which it disagrees, for any reason. Per review of the exposure, there does not appear to be a process that requires the SVO to submit its own rating analysis for the investor to review, or a process that describes why an FE rating was rejected. This creates uncertainty within the market regarding how FE securities will be treated, and the lack of transparency and consistency used within the rating process.

Furthermore, the factors proposed above do not provide consistency of application. The first suggested method, a comparison to peers rated by different CRPs, has historically been an unproven method. This method was initially proposed on November 29, 2021, by the SVO to the VOSTF whereby the SVO challenged the ratings of 43 securities using this method. A subsequent ad-hoc group was formed by VOSTF to evaluate the effectiveness of the SVO's use of the proposed method and VOSTF severely questioned the overall rationale and never ratified or deemed it reliable. Since this proposed method has previously been considered and not endorsed by VOSTF, we suggest that VOSTF remove Section 80 from the proposed amendment.

The second suggested method of using yield to determine credit risk is also unreliable given that market yield differentials do not exclusively reflect creditworthiness. This is because market yield incorporates other risk factors such as liquidity, novelty, and market factors (public vs. private) that cannot be used to assess the validity of credit ratings. Lastly, the IAO's assessment of applying available methodologies is problematic as such methodologies are unspecified and investors do not have a transparent view of how the SVO is rating such securities.

TIAA recommends that a clear methodology be outlined if the SVO is given authority to override certain FE security ratings, as this would provide clarity and ensure fairness in the market. Other safeguards are currently in place that provide support for FE ratings. All FE rated securities have a rating analysis associated with it from a nationally recognized statistical ratings organization (NRSRO) that includes the NRSRO's methodology. The SEC closely regulates all nine of the NRSROs and tracks, in detail, their historical performance, allowing investors to evaluate the quality of their ratings. In addition, all NRSROs are required to provide publicly available detailed methodologies for each type of investment they rate.

III. Conclusion.

We appreciate the opportunity to comment on this important issue. We stand ready to help discuss this proposed amendment broadly across the industry and to work with the VOSTF and SVO to resolve any operational questions or challenges. We hope the comments that we have provided here are helpful and we welcome further discussion on any of the points in this letter.

Sincerely,

Shawnda Martin

Shawnda Martin

July 5, 2023

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

Re: Practices & Procedures (P&P) Manual Amendment Authorizing the Procedures for the Securities Valuation Office's (SVO's) Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears:

We are writing this letter to express our concerns with the proposed amendment referenced above in the subject line. It is our belief that this amendment will have significant negative consequences on private placement market activity and meaningfully impact the ability for private capital to participate in the market.

We would like to note the following considerations:

- Credit rating agencies have detailed and transparent criteria for rating debt products which allows for structuring credit to achieve target ratings with a measure of predictability once rated. These rating agencies have all been approved as NSRO's by the NAIC due to comfort in their rating methodology and track record over time. If the ultimate rating adopted by the SVO can be different from CRP assigned ratings, the ratings outcome uncertainty will make it near impossible to design structures that have predictable outcomes, which is a cornerstone for the private placement market
- The added uncertainty for insurance companies will impact their desire to invest in credit, likely resulting in smaller orders, increased pricing or move to other asset classes. Should this occur, it will impact a vital source of longer term capital for many companies
- Adoption of this proposal would set a precedent and make it appear more likely that additional future negative amendments may be adopted, further increasing the riskiness of investing in private placements

Based on these concerns we strongly recommend that the proposed amendment not be adopted in order to preserve the efficient and smooth workings of the private placement market.

Vlad Delic, Director
BMO Capital Markets Corp.

CC: Charles Therriault, Securities Valuation Office; Eric Kolchinsky, Structured Securities Group

July 14, 2023

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

Re: Proposed Amendment to Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) Amendment Authorizing the Procedures for SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process (memorandum dated April 25, 2023, with proposals and Securities Valuation Office (SVO) staff recommendations)

Dear Ms. Mears:

On behalf of the insurance company members of the Group 1001 insurance holding company system, we appreciate the opportunity to comment on the proposed amendment to the P&P Manual included in the above-referenced memorandum. We have concerns with the current proposal and its probable impact upon capital markets and insurers. As of year-end 2022, privately rated assets accounted for ~44% of insurance companies' bond portfolios according to a publication by ALIRT Insurance Research. The proposal, as currently written, creates significant uncertainty with respect to existing insurance company investments and future market transactions. Uncertainty can lead to the mispricing of assets, illiquidity, inefficient markets, and decision making that is not in the long-term or short-term interests of insurance companies or their policy holders.

We think alternative solutions should be considered and studied to avoid significant disruption to the capital markets and respectfully request that the NAIC and SVO provide industry with additional transparency regarding their concerns. It is unclear whether the proposal is intended to address rating methodology, differences of opinion, or target certain asset types or structures. An issue paper containing specific examples, quantitative analysis, and documented areas of concerns would enable industry and NAIC staff to collaborate to address the NAIC's specific concerns. Moreover, the contemplated scope of the proposal is simply too broad. It would not provide insurers any level of certainty as to whether assets will remain filing exempt if they meet certain criteria (e.g., do not have any 'red flags').

As you are aware, bespoke securities and private assets became a focus for the SVO and the Structured Securities Group (SSG) in 2019. Since then, the VOSTF adopted procedures to gain additional transparency from industry with respect to individual assets. Most notably, insurers

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are now required to file rating rationale reports for privately rated filing exempt assets. When the P&P Manual amendment was adopted to require the filing of rating rationale reports, the purpose was to provide transparency to regulators, with an expectation that the ratings would stand as is and unadjusted. Fiscal year-end 2023 will be the first fiscal year, since requiring the filing of rating rationale reports, in which the SVO will have the technology in place to receive these rating rationale reports from all insurers. We respectfully request that VOSTF first review the rating rationale reports received in 2023, and provide transparency back to industry following such review, prior to implementing additional requirements upon industry.

Furthermore, expected NAIC designations and the associated required capital is a key input in insurance company investment portfolio construction, capital management, and financial planning. Creating uncertainty on expected NAIC designations and, consequently, uncertainty in capital factors will add unnecessary complexity and result in excessive conservatism by industry to the detriment of policy holders. Nationally recognized statistical ratings organizations (NRSROs) are in a distinct position to provide feedback and updates to credit ratings in real time, allowing portfolio managers to make timely decisions. Each NRSRO is unique in its ability to cover certain asset types, sectors, and industries due to their proprietary rating methodologies and retention of staff with expertise and specialization in certain sectors – a critical component to identifying and understanding credit risk. In addition, NRSROs provide transparency into their ratings methodologies, processes, and output.

If this amendment is ultimately adopted, we respectfully request that the SVO offer the same level of transparency to industry as provided by the NRSROs and that the SVO publish the rating methodologies and criteria that it would apply so that insurers could reliably anticipate and form expectations regarding how an asset would be viewed by the SVO. Additionally, we request that the SVO provide a written rating rationale report with respect to any credit rating revoked pursuant to this proposal. Doing so in a timely manner would enable insurers and NRSROs to react and adjust appropriately, both with respect to the subject security and with respect to similar securities with NRSRO ratings.

An additional concern is that the timing of this proposal coincides with the upcoming implementation of the principles-based bond definition, also known as the “Bond Project”. The Bond Project was started to address regulator concerns about certain assets that are reported on Schedule D and therefore filing exempt, and its impact constitutes a significant accounting change that has cascading effects, including causing insurers to undertake in-depth review and analysis of existing assets and the potential to materially affect capital and risk-based capital ratios. We expect that implementation of the Bond Project will address the same concerns this proposal is meant to address, and we urge the NAIC to allow implementation of the Bond Project to run its course before imposing upon insurers additional, overlapping regulatory requirements as set forth in this proposal.

We also ask that the VOSTF implement an independent appeal process to review disputes between the SVO and industry. In addition to the potential for disputes to arise because of this proposal, we believe that implementation of the Bond Project could lead to additional disputes between insurers and SVO staff due to the principals-based nature of the accounting standard and the degree of judgement to be exercised thereunder. If the SVO or a regulator were to disagree with the conclusion reached by a NRSRO, and the insurer believed the SVO's or regulator's conclusion was reached in error (whether due to lack of specific knowledge, a difference of professional opinion, or some other factor) an avenue for the insurer to appeal to an impartial and independent group with appropriate experience would be beneficial to all stakeholders.

In summary, we ask that this proposal be postponed and only reconsidered after the following has occurred:

- The publication of an issue paper detailing the specific concerns of regulators and the SVO following the review of the 2023 filed rating rationale reports and the subsequent collaboration between industry and the NAIC to arrive at a solution.
- The scope of potentially impacted securities is more narrowly defined.
- The impact of the Bond Project on the scope of this issue is understood.
- An independent appeal process is adopted; providing proper checks and balances to dispute resolution procedures.
- The SVO publishes its rating methodologies and develops standards similar to those applicable to NRSROs.

Sincerely,

Bob Turner
Director, Investments

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michellesdelany@gmail.com

Ms. Carrie Mears, CFA
NAIC
Valuation of Securities Task Force

RE: Public Meeting Comments – May 15, 2023 - Comments on proposed due diligence

Dear Ms. Mears:

Nationally Recognized Statistical Ratings Organizations ("NRSRO") are for-profit entities, whose business is assessing the creditworthiness of issuers of debt, including but not limited to the issuers ability to repay the debt, likelihood of default and expectation of loss. Ratings agencies use various methodologies which they have developed and perfected over many years in the industry.

NRSRO's are regulated by the Securities and Exchange Commission ("SEC") and go through a rigorous application process and annual review of their methodology. The SEC adopted rules relating to the oversight of NRSRO's, in response to the requirements of the Credit Rating Agency Reform Act of 2006 and were enacted to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating agency industry.

NRSRO's must apply for registration with the SEC, make public certain information to help assess their credibility and implement procedures to manage the handling of material non-public information and conflicts of interest.

Credit ratings have been used extensively in financial regulation, including insurance regulation. Particularly for debt instruments, as with any extension of credit, the four Cs of credit are a critical aspect of the analysis. Character, Cash Flow, Collateral and Credit…these help the analyst to determine not only the creditworthiness of the borrower, but also the primary, secondary and tertiary source of repayment of the debt. NRSRO's are keen on analyzing the cash flow, but more importantly, they put eyes on the collateral, which in many cases is the most important. As an example for an investment property with anchor tenants, prudent analysis would warrant not only reviewing the lease terms, but also researching the tenant history to be sure that there are no issues with their payment history with their vendors. One can point to strip malls around the country which sit partially leased, because the anchor tenant moved out or worse yet went bankrupt, thus interrupting the cash flows and ultimately the borrowers ability to pay the debt service.

As a former portfolio manager / treasurer of a large regional bank, in addition to my own analysis, I have relied on the analysis of NRSRO's and the credit ratings issued to assist with investment decisions for the bank portfolio. The banks primary regulator, the OCC, in conjunction with the FDIC through the Federal Financial Institutions Examination Council, determines the leverage ratio for specific asset classes. That leverage ratio provides a risk weighting for the banks Capital Ratios, including total risk-based capital (Tier 1 and 2). **The regulators, however, do not issue ratings or designations.**

The SEC, EMSA and FCA conduct robust reviews of ratings firms and intentionally do not engage in issuing ratings themselves. All are considered independent and balanced in their approach.

It is highly unusual for a de-facto regulator (i.e., the SVO) to also be a market participant (i.e., by issuing designations), which for all practical purposes are ratings. The SEC does not conduct broker dealer operations, manage money, nor operate a stock exchange. Sound markets are critical to the health of our financial markets and our country.

If the SVO designations serve the same role as ratings, then they should be subjected to the same due diligence scrutiny by an independent review such as the SEC. For example, a publication of methodologies for publishing ratings/designations, annual reviews of methodologies and models, separation of the business and analytical side.

Due diligence on key suppliers is in best interest of all parties. However, to be most effective, the review should be completed by an independent third party and apply equally to all providers while relying in part on work done by other reviewers/regulators such as the SEC. The SVO has an inherent conflict because of its roles as both a de-facto regulator and a provider of ratings services and is not the appropriate party to conduct the review. Furthermore, there is no plausible reason why the SVO, which provided nearly 13,000 designations/ ratings should be excluded from a review.

The SVO claims that because it is overseen by state regulators, its ratings are superior. However, as stated above, NRSRO's are heavily regulated by a group within the SEC, which specializes in overseeing ratings firms. All rating firms are ultimately paid via the proceeds of transactions, and if the ratings were false or inaccurate, investors and issuers would restrict usage by those firms and the markets would follow suit by not buying the securities, thus creating a grave market disruption.

Following standard procurement policies and procedures, the NAIC, should issue and RFQ / RFP for third party entities to perform an arms-length review of the NRSRO's, including the SVO...The cost of contracting with the third-party consultant to perform this due diligence could be borne by the rating agencies.

Thank you for reviewing my comments.

Very truly yours,

Michelle S. Delany

July 26, 2023

The National Association of Insurance Commissioners (NAIC) is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators of the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, NAIC Members, in their capacity as state insurance regulators, establish standards and best practices, conduct peer review, and coordinate regulatory oversight. NAIC staff supports these efforts, representing the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S. The NAIC is not itself a regulatory entity.

Committees composed of NAIC members conduct the work of the Association. The NAIC has determined that credit quality of insurance company investments provide a sound empirical anchor for certain regulatory functions related to financial solvency regulation. The Valuation of Securities (E) Task Force (VOS/TF) reports to the Financial Condition (E) Committee and formulates and implements NAIC's credit assessment and related policies. The Securities Valuation Office (SVO) are the professional staff assigned to support the VOS/TF. The SVO conducts credit quality assessments of securities owned by state-regulated insurance companies and performs such other duties specified by VOS/TF in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) or assigned by other NAIC regulator groups, from time to time.

The P&P Manual collects the cumulative policies of the VOS/TF, identifies the procedures and methodologies adopted by the VOS/TF for credit assessment of insurer-owned investment securities and provides information on the operational and administrative procedures conducted by the NAIC, the SVO and the Structured Securities Group (SSG) to support the VOS/TF. The P&P Manual is authoritative on these topics over other NAIC publications. The P&P Manual describes the NAIC's use of credit ratings of rating organizations that have been designated a Nationally Recognized Statistical Rating Organization (NRSRO) by the U.S. Securities and Exchange Commission (SEC). The core policies covering the use of credit ratings are in P&P Manual, Part One, paragraphs 58-62, and Part Two, paragraphs 155-163 which is listed below along with a link to the full manual that contains additional references and instructions beyond these core policies related to the use of credit ratings.

To better support the credit assessment processes dependent upon credit ratings, the VOST/TF has compiled the following series of questions that it requests you to respond to in writing and submit back the SVO staff within 30-days. After your responses have been received, the SVO staff will follow up with you to schedule a private meeting with the VOS/TF members and NAIC staff to discuss your comments and answer any additional questions from the VOS/TF members, NAIC staff or yourselves.

Thank you in advance for responding to our questions.

NAIC Questions for Credit Rating Providers (CRP):

Regulation

1. Please describe what role, if any, credit ratings have or should have in relation to insurer financial solvency regulation, both now and in the future.
2. Do you consider the implications of regulatory capital under your ratings methodology; specifically, insurance regulatory capital?

Ratings Meaning and Performance

3. How do you define your ratings?
4. What are your ratings based/anchored on?
5. What, if any, performance expectations do you have for each rating category?
6. Do you have idealized expected loss given default percentages for each rating? Does it differ across methodology or asset class? Over what time period are they calculated? Do you publish them and/or publish a comparison of actual experience to them?
7. How do your ratings measure statistical tail-risk?
8. Under what circumstances or situations would you decline to rate a security?
9. Under what circumstances or situations would you withdraw a security's rating?
10. Describe if and how you use market data (e.g. credit default swaps pricing, bond market yield spread to USTs or some other observable metric) within your ratings process.
11. Describe the differences between your solicited and unsolicited ratings.
12. What percentage of your ratings are point in time versus continuously monitored?
13. Please describe the differences between your public and privately issued ratings.
14. What is your percentage distribution of ratings by assets class and security type (as described in your methodologies)?
    - Public vs. privately issued
    - Solicited vs. unsolicited
    - Withdrawn
15. Do you have the ability to provide the ratings performance by asset class over specific time periods, to the extent available?
16. How do you assess the quality and performance of your ratings?
17. How do you rate the following types of securities?
    - Feeder fund / rated notes
    - Closed end funds
    - Structures securities
    - Nested or compound securities (e.g. CLO Combo Notes, an SPV that invests in funds that issues notes)
    - Securities that do not have events of default or payment expectations (no scheduled principal or interest payments)
    - Securities that can defer interest more than 24-months.

Ratings Procedures and Processes

18. Which committees, persons/roles or entities can challenge an analyst rating and who is involved in this process? What level is this in the organization and is this a formal process?
19. How do you report withdrawn ratings on your Form NRSRO transitions and cumulative default statistics?
20. What would cause you to change a methodology? And how is the credit committee involved with setting methodologies?
21. Describe the main steps of your ratings assignment process?
22. What Is your process for developing / changing a rating methodology?

Internal Controls

23. Has your firm or an employee been fined or otherwise penalized by the SEC's Division of Enforcement in the past 10-years? If so, please describe each situation, the penalties and any remediation measures required and/or taken.
24. Describe your firm's governance policies and control structure. What are the key elements of your process that safeguard the independence of your ratings/ratings process, and prevent prohibited conflicts of interest?
25. Are your governance/oversight practices consistent for every asset class and type of rating? If not, explain the differences.
26. How many insurance industry related clients (e.g. insurance companies, group or entities that own/manage insurance companies, insurance company investment portfolios, or issue securities primarily for insurance companies) do you have whose fees exceed 1% of your total revenues?
    - What percentage of total revenues are they?
    - List those clients, if applicable.

Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)

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

The Use of Credit Ratings of NRSROs in NAIC Processes

Note: See "Policies Applicable to the Filing Exemption (FE) Process" below; "NAIC Policy on the Use of Credit Ratings of NRSROs" (especially "Definition – Credit Ratings Eligible for Translation to NAIC Designations") in Part Two (the definition of "Eligible NAIC CRP Credit Ratings" excludes the use of any credit rating assigned to a security type *where the NAIC has determined that the security type is not eligible to be reported on Schedule D or that it is not appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of the security or asset*); and "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three.

Providing Credit Rating Services to the NAIC

58. The NAIC uses credit ratings for a number of regulatory purposes, including, to administer the filing exempt rule. Any rating organization that has been designated a Nationally Recognized Statistical Rating Organization (NRSRO) by the U.S. Securities and Exchange Commission (SEC) and which continues to be subject to federal regulation, may apply to provide Credit Rating Services[1] to the NAIC.

Policy and Legal Disclosure Pertaining to the NAIC Credit Rating Provider (CRP) List

59. The NAIC uses publicly available credit ratings, when available, as one component of the services it provides to state insurance regulators concerned with financial solvency monitoring of insurance company investments.

60. In adopting or in implementing the procedure described in this section, the NAIC acts solely as a private consumer of publicly available credit ratings. The sole NAIC objective in obtaining and using publicly available credit ratings is to conserve limited regulatory resources; e.g., the resources of the SVO. The VOS/TF has established the procedure specified in this section solely to ensure that the NAIC can avail itself of publicly available credit rating opinions.

[1] **Credit Rating Services** is defined as: (a) electronic data feed transmissions of credit ratings assigned by the NRSRO with their corresponding CUSIP number and other pertinent security specific information in English, updated as frequently as provided to other customers; (b) other analytical services or products, in English, provided to other customers; and (c) access to the NRSRO's rating analysts by SVO staff.

No Waiver/Express Reservation of Authority

61. Nothing in this section should be interpreted or construed as a waiver of the authority of the VOS/TF, in its sole and absolute discretion, to modify or change, in any manner whatsoever, the NAIC Policy on the Use of Credit Ratings of NRSROs, including but not limited to:

    - Directing the removal of one or more NRSROs from the NAIC Credit Rating Provider List (subject only to the adjustment of any existing contractual obligations);
    - Directing the SVO to study any issue related to NRSRO operations in furtherance of state insurance regulatory policy;
    - eliminating the NAIC Credit Rating Provider List; or
    - Directing any other action or activity the VOS/TF may deem to be useful or necessary to the creation, maintenance or discharge of state-based regulatory policy.

62. The NAIC is not selecting, approving or certifying NRSROs or other rating organizations or distinguishing among them for any public or policy purpose whatsoever. Nor is the NAIC endorsing the credit rating or analytical product of any CRP or rating organization or distinguishing between CRPs or rating organizations for any specific public purpose. The NAIC disclaims any authority to regulate CRPs or rating organizations.

PART TWO: OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

NAIC POLICY ON THE USE OF CREDIT RATINGS OF NRSROS

NOTE: See "Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force, "Use of Credit Ratings of NRSROs in NAIC Processes" and "Policies Applicable to the Filing Exemption (FE) Process" in Part One; "Definition – Credit Ratings Eligible for Translation to NAIC Designations in this "NAIC Policy on the Use of Credit Ratings of NRSROs"; "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three; and "Filing Exemption Status of RMBS and CMBS" in Part Four, which excludes RMBS and CMBS from the use of NRRO credit ratings for NAIC regulatory processes.

Procedure to Become an NAIC Credit Rating Provider

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

- Indicates an interest in providing Credit Rating Services to the NAIC.
- Confirms that it is currently an NRSRO subject to regulation by the SEC.
- Provides a chart relating its credit rating symbols to NAIC Designations.
- Indicates that the NRSRO agrees to enter into a legally binding agreement under which the NRSRO will:
    - Provide Credit Rating Services to the NAIC at no cost;
    - Reimburse the NAIC for all costs associated with: integration of its data feed into NAIC systems, subsequent changes to NAIC systems to accommodate changes in the NRSRO's systems and changes to NAIC systems as a result of the termination of Credit Rating Services by the NRSRO;
    - Give written notice 6 months prior to terminating Credit Rating Services; and
    - Agree not to claim in marketing literature that the provision of Credit Rating Services indicates NAIC approval or endorsement of the NRSRO, its products or services.

156. Adding the NRSRO to the NAIC Credit Rating Provider List When directed to do so by the VOS/TF, the SVO shall add the name of the NRSRO (hereafter described as a Credit Rating Provider (CRP)) to the NAIC Credit Rating Provider List in the publication of this Manual that follows the execution of an agreement between the NAIC and the NRSRO.

Regulatory Significance – Filing Exempt Rule

157. Adding the name of an NRSRO to the Credit Rating Provider List indicates that insurance companies must use the credit ratings assigned by that NRSRO, if any, when determining the NAIC Designation equivalent for a security to be reported under the filing exempt rule. Only those NAIC CRP ratings that meet the definition below may be translated into NAIC Designations under the filing exempt rule. Securities assigned ratings by NAIC CRPs that do not meet the definition below, shall be filed with the SVO. The translation of a NAIC CRP rating into an NAIC Designation is conducted in accordance with the procedures described in this Manual.

Definition – Credit Ratings Eligible for Translation to NAIC Designations

158. As disclosed below, the NAIC may determine that the rated security or investment is of a type that is not eligible to be reported on Schedule D or that the NAIC determines is not appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of a specific asset class, as specified in this manual.

159. The credit rating of the CRP to which this section and the NAIC Credit Rating Provider List refers is the (a) credit rating assigned by the NAIC CRP; (b) by application of its long-term obligation ratings scale and methodology; to (c) securities.

160. Credit ratings of a NAIC CRP that meet this definition are entitled to a presumption of convertibility to the equivalent NAIC Designation published in the NAIC Credit Rating Provider List except that the presumption of convertibility is subject to the following limitations:

- Those rating activities or markets in which the entity has NAIC CRP status.
- Securities with monitored NAIC CRP ratings that:
  - Are monitored at least annually by the CRP that issued the rating;
  - Are assigned to a specific issue that must be specifically identified;
  - Apply to securities where the issuer promises to repay principal and interest or dividends;
  - Convey an opinion as to the likelihood of payment of both principal and interest/dividends due from the issuer to the holders of the security; or
  - Are structured to pay only principal or only interest/dividends, if the monitored NAIC CRP rating addresses the likelihood of payment of either the principal, in the case of a security structured to pay only principal or the interest/dividends, in the case of security structured to pay only interest/dividends (an "Eligible NAIC CRP Rating").

161. The NAIC may determine that the rated security or investment is of a type that is not eligible to be reported on Schedule D or that the NAIC determines is not appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of a specific asset class, as specified in this manual.

Special Rating Systems

162. Unless otherwise specifically approved by the VOS/TF special rating systems of any CRP, rating agency or rating organization shall not be entitled to a presumption of convertibility. Nevertheless, an SVO analyst assessing a security that has been assigned such a rating by any rating organization, including a CRP, may consider the information imparted by that rating or a related research report as one factor in determining an NAIC Designation.

Disclosures and Considerations Related to the Translation of Credit Ratings into NAIC Designations

163. The presumption of convertibility accorded to a credit rating of a NAIC CRP should not be interpreted to indicate that NAIC Designations and NAIC CRP credit ratings are produced using identical methodologies or that they are intended to communicate the same information. SVO credit assessment is conducted for regulatory purposes and may therefore include considerations or address concerns unique to the regulatory community.