# Draft Pending Adoption

Draft: 12/12/2023

Valuation of Securities (E) Task Force
Orlando, Florida
December 2, 2023

The Valuation of Securities (E) Task Force met in Orlando, FL, Dec. 2, 2023. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Eric Dunning, Vice Chair, represented by Lindsay Crawford and Nolan Beal (NE); Mark Fowler represented by Sheila Travis and Blase Abreo (AL); Lori K. Wing-Heier represented by David Phifer (AK); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone (CT); Michael Yaworsky represented by Carolyn Morgan, Jane Nelson, and Ray Spudeck (FL); Dana Popish Severinghaus represented by Vincent Tsang (IL); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Kathleen A. Birrane represented by Matt Kozak and Dmitriy Valekha (MD); Grace Arnold represented by Fred Andersen (MN); Chlora Lindley-Myers represented by Debbie Doggett (MO); Jon Godfread represented by Matt Fischer (ND); D.J. Bettencourt represented by Jennifer Li (NH); Justin Zimmerman represented by David Wolf (NJ); Adrienne A. Harris represented by Bob Kasinow and Jim Everett (NY); Glen Mulready represented by Diane Carter and Eli Snowbarger (OK); Michael Humphreys represented by Diana Sherman (PA); Carter Lawrence represented by Trey Hancock (TN); Cassie Brown represented by Amy Garcia and Jamie Walker (TX); Jon Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Steve Drutz (WA); and Nathan Houdek represented by Amy Malm (WI). Also participating was: John Tudino (RI).

1. <u>Adopted its Summer National Meeting Minutes</u>

Doggett made a motion, seconded by Clements, to adopt the Task Force's Aug. 14 minutes (*see NAIC Proceedings – Summer 2023, Valuation of Securities (E) Task Force*). The motion passed unanimously.

2. <u>Heard a Staff Report on The History of FE</u>

Mears said the next item is to hear a staff report on the history of filing exemption (FE), the role of the Securities Valuation Office (SVO), and the SVO's discretion. State insurance regulators heard this report during the Fall Education Seminar and found it informative since many have not been around for this entire history. It is also informative as the Task Force moves forward with the review of reliance on rating agencies.

Marc Perlman (NAIC) said at the request of the Task Force chair, the next few minutes of the meeting will be history lesson with a walk-through of the evolution of the use of third parties, rating agencies, the SVO, and FE in the assessment of insurer investments. With the significant debate around reintroducing a form of SVO discretion over ratings, Mears thought a little context might be helpful to demonstrate that this recommendation is not an aberration but rather a return to what had been the norm.

For this report, there was an extensive review of NAIC minutes and old versions of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). The report covers a lot of ground and a lot of years, so the research is not exhaustive but, especially with those early years, it will give a sense of how centralized valuations developed, who was tasked with doing them, and the use and role of rating agencies in the process.

In September 1907, Massachusetts first raised concerns about discrepancies in insurer valuation practices. This was prescient because a month later there was a financial panic after which the New York Department of

 

## Draft Pending Adoption

Insurance (DOI) and the NAIC Committee on Assets revisited the topic and suggested finding an expert to value insurer investments for all departments.

By 1909, the NAIC had convened a Committee on the Valuation of Securities, which was to become the sole source of values. It decided to outsource this task to an expert in the field. In December 1909, the Committee signed a contract for $5,000 with Marvyn Scudder, Esq. of 55 Wall Street to produce all valuations. Scudder had been called the country's foremost stock detective and was the editor of the "Marvyn Scudder Manual of Extinct and Obsolete Companies."

Scudder produced a valuations book each year through 1928, at which point the Committee on the Valuation of Securities contracted with Poor's Publishing Company (the predecessor to Standard & Poor's [S&P]), pursuant to which it would determine all values. In 1939, Moody's Investor Service (Moody's) got the contract.

In 1934, the topic was broached of the NAIC creating a Statistical Bureau of its own, available to the Insurance Commissioners of all states to appraise, value, and analyze insurance company portfolios and publish a valuations book much like Scudder and S&P had done. That would not happen for another ten years.

In the early 1930s, there were discussions that not all bonds should be reported at market value because "value" can fluctuate, often for reasons unrelated to the creditworthiness of the issuer. There was discussion that bonds that were deemed "amply secured" should be valued on an amortized—or a long-term stable basis—rather than the market value at which a security would be liquidated.

In 1941, a change was implemented to distinguish between bonds that could be amortized and those that would be valued at market value. Credit ratings were used as a test of amortization eligibility. Bonds rated by any two of Moody's, S&P, and Fitch (the only agencies at the time) in any of the first five grades, would be deemed "amply secured" and eligible for amortization.

In 1943, the Committee stopped using external consultants, as Moody's didn't extend its contract due to wartime responsibilities. The Committee undertook to perform all valuations and amortization determinations itself and leased a space at 61 Broadway. In the next two years that office was staffed and the Office of the Committee on Valuation of Securities was created, which later became the Securities Valuation Office (SVO).

It should be noted that at the time of its establishment, this precursor to today's SVO, just like Marvyn Scudder, S&P, and Moody's, was intended to be an independent, expert, and impartial source of investment values and amortization determinations.

By 1949, the volume of private placements was growing quickly. Each was reviewed by the Office, but there was discussion about expanding the office to meet the growing demand as well as the difficulties the Office faced in producing valuation and amortization determinations for private securities based on whatever financial information it was able to gather because there was no market value. To be clear, these were corporate bond private placements, not the more complex structured private placements we see today.

Two years later, this debate was ongoing and there was an interesting summary presented at the 1951 National Meeting of the analytical standards being used by the Office and critiques of those standards. Regarding the use of ratings to determine amortization eligibility, the report said, "The principal objection to this phase of current valuation procedure is the Committee's reliance upon the opinions of rating agencies whose approach and objectives may differ from those employed by the technical staff of the Committee." Regarding the Office's valuation of private placements, the report said, "The limitations upon this portion of the valuation method

## Draft Pending Adoption

arise primarily from a lack of readily available and sufficient information concerning publicly traded bonds with which to compare the securities under review."

By 1953, the Committee adopted an analytic approach that remained relatively unchanged until 1989. Under this approach, which was refined from time to time, investments were given "Association Values." For bonds, the association value was comprised of two parts: a numerical notation and a statement as to eligibility for amortization. The amortization eligibility component could be thought of as the NAIC's quality opinion. The approach specified two analytic tests containing different standards for different entities, such as railroad, public utility, new enterprise, etc. The tests specified certain levels of standard bond analysis techniques. In Test 1, a corporate obligation would be eligible for amortization if it were rated in one of the four highest grades (i.e., investment grade) by any one of the recognized rating agencies. If it weren't, it could still be amortized if it met certain other financial ratios.

Even then, the results of the two tests were subject to further review and examination for any cases having predominant weakness or strength. In other words, the Office had discretion. As explained by the Office, "Because it is difficult to apply standardized tests to the wide variety of obligations which are purchased by insurers, the valuation procedures provide for the exercise of discretion in determining the qualitative and reserve categories for bonds not susceptible of measurement by such measures."

With the same basic analytic approach in place for 30 years, by the mid-'80s there was a move to revamp the valuation procedures. In December 1986, the Financial Condition (EX4) Subcommittee created a Bond Criteria (EX4) Subgroup of the Valuation of Securities (E) Task Force and charged it "to update and revise the financial ratio criteria and industry breakdowns" in the bond section of the SVO Procedures (precursor to the P&P Manual). Two industry advisory groups (called the A Group and the B Group) were then created to assist the Bond Criteria (EX4) Subgroup. In a 1988 report by the B Group, industry professionals from Morgan Stanley, Merrill, Moody's, S&P, Solomon Brothers, and Drexel Burnham discussed the need for a "reasonable" solution to the SVO's regulatory and analytical charge in light of its resource limitations. The Subgroup recommended the SVO take advantage of publicly available credit analysis and the results of existing financial research to screen out those debt investments that posed nominal default risk so it could focus on the issues with greater risk or where publicly available analysis did not exist. The Subgroup also said that for those investments requiring more in-depth review, the SVO should exercise significant discretionary analysis and authority utilizing all quantitative and qualitative analytical factors that it deemed necessary. It went on to say that it "wholeheartedly" agreed with the A Group, that "the SVO retain discretionary authority to review any situation warranted by specific facts and circumstances."

Finally, in 1989, revamped analytic guidelines were created in the then new P&P Manual. The guidelines said that, where appropriate, the SVO would use the Zeta Services quantitative financial model and past financial statement data to determine a preliminary measure of the relative financial soundness of the issue. The model, however, was not intended to be the sole determinant of the NAIC Designation. Rather, the SVO would review historical financial data and focus on security-specific factors, including covenants, structure, collateral, and ratings, which were just one element of the review.

The following year, the P&P Manual was changed to say that ratings of other recognized rating organizations would be translated directly into an NAIC designation. However, "The SVO staff will have discretionary authority to downgrade ratings of other organizations but not to upgrade." It was also the year that "Yes" and "No" designations were replaced with the 1–6 used today.

 

**Draft Pending Adoption**

The 1992 P&P Manual explained the relationship to nationally recognized statistical ratings organization (NRSRO) ratings, saying that NAIC guidelines and procedures promulgated by the Task Force permitted the SVO to incorporate or adopt work product of NRSROs or other reliable securities research organizations in lieu of determining an independent valuation for a security. The P&P Manual had a conversion table, but it did not imply an equivalency between NAIC designations and NRSRO ratings. However, the P&P Manual also said that the SVO retained absolute discretion to apply a lower designation.

In 1996, a distinction between public and private ratings was made with public ratings usually being granted automatic translation, with the caveat that the SVO retained discretion. Private ratings, however, were subject to full SVO review of the factors that may not be included in the NRSROs public ratings.

The following year, the P&P Manual included another qualifier regarding the use of NRSRO ratings. It said "the NAIC uses NRSRO ratings in order to conserve limited regulatory resources and to obtain publicly available high quality credit opinions. While NAIC Designations reflect the staff's opinion about credit risk, the staff must address concerns unique to the regulatory community. Nothing in this manual should be interpreted as implying that the methodologies by which traditional or special NRSRO ratings are produced are identical to the manner in which the SVO considers credit risk for regulatory purposes, or to imply automatic equivalency of NAIC Designations with the ratings of NRSROs."

Until this point, with certain rare exceptions (such as highly rated commercial paper), all securities needed to be filed with the SVO. Thus, even if the SVO just looked to ratings for a determination of amortization or to assign a designation, the SVO was seeing every insurance company investment and it had very few blind spots as to what insurers were investing in.

At this point, however, the movement toward what was called provisional exemption had begun. Provisional FE became effective Jan. 1, 2000, and under Provisional FE, both traditional bonds and asset-backed securities (ABS) rated by two or more NRSROs with the equivalent of an NAIC 2 Designation or one NRSRO with the equivalent of an NAIC 1 designation would not need to be filed with the SVO. There were certain other requirements to qualify for Provisional FE. For example, the security had to be issued by a U.S. entity and paid in U.S. dollars, principal had to be paid in full by a fixed maturity date and, in the case of ABS, only certain asset classes were permitted. Even with provisional FE, though, the P&P Manual cautioned that the SVO would not be able to monitor any market innovation or regulatory risk and it maintained SVO discretion. Provisional FE did not limit the SVO's authority to require a filing that would otherwise be provisionally exempt.

The main question is why provisional FE was adopted. In 1996, there was a letter from the Joint Trades to the Task Force that focused on the SVO's lack of resources and industry's dissatisfaction with SVO efficiency at that time. A trade association recommended that insurers not need file non-structured securities rated investment grade by an NRSRO. Around the same time, an SVO Oversight Working Group was created to monitor SVO operations and to be a mechanism by which industry could raise concerns about the SVO. This oversight group conducted what it called the SVO Efficiency and Effectiveness Project, with the intended goal of increasing usage by the SVO of NRSRO ratings. At the same time, the NAIC hired outside consultant KPMG Peat Marwick to produce an independent report of the SVO and an SVO Subgroup of the Executive Committee conducted a study in response, which adopted and rejected some of KPMG's recommendations. Both reports were presented in regulator-only sessions, and copies of the report have not been located. There was also a supposed public 8-page summary of the report, but that was also not located. However, based on subsequent minutes, it appears that the reports recommended greater reliance on ratings and provided a basis for provisional FE, likely due to the SVO's efficiency and resource problems at that time.

 

## Draft Pending Adoption

The Task Force, Oversight Working Group, and some in industry had concerns with reliance on NRSROs, and the joint trades addressed that in another letter. There were concerns, for instance, about private placements. The joint trades argued those were a minority of insurer investments but conceded they might require additional due diligence. There was a concern about ratings shopping or inflation with some arguing that an AAA threshold would promote the search for higher ratings. The Joint Trades did not think that should be concerned since NRSROs are judged by the quality of their ratings, presumably meaning that they would not reduce standards.

Others argued that ratings inflation would be an NRSRO accreditation problem rather than an FE problem. Moody's noted that ratings creep could become a problem if rating agencies were used for regulatory purposes, since the issuer would place more emphasis on receiving a higher rating rather than an accurate one. Moody's also said that reliance on ratings would have more impact on the less liquid markets, including private placements and structured securities. The trade associations, however, did reiterate that the provisional FE proposal did not affect the SVO's ability to request information about any security when it believed it to be necessary.

There was a lot of discussion about which ABS asset classes would be permitted. Certain state insurance regulators, industry, and staff had concerns that the change would limit the SVO's ability to fulfill its "eyes and ears" function, its role in spotting market innovation and risk. One SVO analyst warned of then-recent developments in a potentially riskier "subprime" asset class. There were also discussions about whether NRSROs should or can be differentiated. Some said the SVO could not currently differentiate between agencies because it had not been given the tools to objectively evaluate them. Others said the SVO Oversight Working Group should address NRSRO concerns directly with the NRSROs. Also, a 1994 Federal Reserve Report was cited, which said, "Differences [between rating agencies] can be highly problematic for ratings-based regulation in which ratings of any two NRSROs are substitutable."

Provisional FE was adopted for the start of 2000. In anticipation of its adoption, industry produced a frequently asked questions (FAQ) document for its roll-out. Question #3 was: "Why does the language say, 'provisionally exempt'?" The answer was that insurers have no irrevocable "right" to exemption from the filing of securities and the SVO and state insurance regulators will maintain the authority to request filings of securities that are provisionally exempt.

Soon after provisional FE became effective, attempts to expand the scope of exemption began. The SVO Oversight Working Group charged the SVO and interested parties with analyzing the feasibility of including non-NRSRO ratings, though this did not gain traction because it was argued that the Task Force was relying on U.S. Securities and Exchange Commission (SEC) recognition of NRSROs because the SVO did not have the staff to conduct an independent analysis and make those determination for each rating agency.

Then, there was a proposal for subsequent exemption, which would have exempted certain securities with optionality features from annual updates. That, too, failed to gain traction. Other state insurance regulators discussed the possibility of the SVO reviewing every security at least once but then defining classes of securities that would be FE.

In 2003, there was the first proposal for full FE. It had three components: 1) exemption for all NAIC 1 and 2 rated equivalent securities (ignoring the several limitations imposed by provisional exemption, which, for example, only applied to U.S. issuers paying US dollars); 2) FE for NAIC 3–6 rated equivalent securities; and 3) an alternative to SVO review of unrated securities. This part of the proposal called for insurer self-designation.

 

## Draft Pending Adoption

Some of the rationale for full FE was that: 1) NRSRO ratings are sufficient to establish quality and the Oversight Working Group said it was comfortable with NRSRO ratings, particularly issues that were rated by multiple NRSROs; 2) the SVO was not using its discretionary authority very often and some said FE would turn an implicit reliance on ratings into an explicit one; 3) a new SVO Research Unit (created as part of the Efficiency and Effectiveness Project) could play the main "eyes and ears" function of the SVO and the SVO's limited resources could be directed there; 4) it was argued that ratings focus on credit risk, whereas the SVO could focus on other non-credit risks affecting solvency; 5) insurer self-designation would make the SVO more efficient; and 6) it was argued that the NAIC had the power to withdraw an NRSRO from FE eligibility if it did not meet regulatory purposes.

Some argued against the full FE proposal or parts of it. Some of those arguments were that: 1) there was more volatility in below investment grade rated securities; 2) NAIC designations do not match ratings exactly; and 3) self-designation was particularly unpopular with regulators, even those who supported full FE. They said it just does not work since competitive business pressures compromise it and investors focus on risk and return while the regulators' approach to quality may differ. Additionally, self-designation could result in different designations for the same security and would turn the process, which had been uniform for the 100 years, into a fragmented one once again.

In any event, the SVO Oversight Working Group saw little regulatory risk in relying on NRSROs. A modified version of full FE was adopted and became effective in 2004. This version scoped in NAIC 1–6 rated equivalent securities and included ABS, residential mortgage-backed securities (RMBS), and structured securities. In this version, private ratings were included while principal-only ratings were excluded.

Since then, full FE has undergone occasional adjustments. FE has been trimmed back, with several asset classes being expressly scoped out. Some, like RMBS, commercial mortgage-backed securities (CMBS), and now collateralized loan obligations (CLOs) have been handed to the Structured Securities Group (SSG). In Part Three of the P&P Manual, there is a list of other investments that are no longer eligible for FE. Credit tenant loans (CTLs) and ground leases on that list refer to the those defined in the P&P Manual as mortgage loans in the scope of *Statement of Statutory Accounting Principles (SSAP) No. 37—Mortgage Loans* and not investments in securities that are eligible for FE.

To conclude, FE has been in use for 20 years. It is what most know, is obviously quite important, and is not going away. However, there has never been an absolute right to use rating agency ratings, including today. The Task Force and its predecessors have always retained the right to use ratings as they think appropriate. For most of the Task Force's and SVO's existence, even when the Office relied on ratings for certain aspects of valuation or designation, the Office was considered the independent, impartial expert (and remains so today) and its discretion was permitted and viewed by state insurance regulators and many in industry as an important and necessary feature of the valuation/designation process.

Chris Anderson (Anderson Insights LLC) said it is important to distinguish when the SVO valued securities and when it began assessing risk. The SVO valued securities and published a book of association values. In 1951, there was a mandatory securities valuation reserve (MSVR), which some may remember when credit became an element. With the adoption of risk-based capital (RBC) in the early 90's, the role of the SVO transitioned and is now credit focused and not the valuation office that it used to be. The takeaway is that risk metrics like MSVR and RBC were important drivers of the history of the SVO.

3. Received a Referral from the Statutory Accounting Principles (E) Working Group on Changes Proposed for Schedule BA Investments and a Recommendation From the SVO on Those Changes

## Draft Pending Adoption

Mears said the next agenda item was to receive a referral from the Statutory Accounting Principles (E) Working Group on its proposal to report debt securities that do not qualify as bonds on Schedule BA. A key component of the notice was to highlight that the proposal uses existing Schedule BA reporting provisions for SVO-assigned NAIC Designations in determining RBC. This referral was sent to the Task Force and the Capital Adequacy (E) Task Force. The SVO staff prepared a recommendation, and Charles Therriault (NAIC) provided a summary of that recommendation. The Task Force could then consider how it would like to respond to the Working Group and Capital Adequacy (E) Task Force on this matter.

Therriault said the Task Force has an existing policy in the P&P Manual in Part One, paragraphs 40 and 99, and instructions to the SVO in Part Two, paragraphs 209–212, that permit the SVO to assign NAIC Designations to Schedule BA assets.

SVO staff strongly recommend the continuation of the long-standing existing policy of only allowing the bond RBC factors associated with NAIC Designations assigned by the SVO to investments appropriately reported by insurers on Schedule BA. The nature of the investments on this schedule can vary widely and are often highly bespoke, which demands a higher level of regulatory scrutiny before being granted this favorable treatment. The adopted revisions to the definition of a bond following the principles-based bond project likely means that more unusual investments will be moving to Schedule BA. Keeping the process as-is will also align with the Task Force’s efforts to reduce blind reliance on rating agency ratings. The SVO would also recommend the recognition and treatment of SVO-assigned NAIC Designations to investments on Schedule BA be made consistent and uniform across all statement types, as only life and fraternal insurers benefit today.

Mears, hearing no objections or concerns from the Task Force on the SVO’s recommendation, said the recommendation would be communicated to the Capital Adequacy (E) Task Force and eventually the Risk-Based Capital Investment Risk and Evaluation (E) Working Group.

4. Exposed a Proposed P&P Manual Amendment to Update the Definition of an NAIC Designation

Mears said the next agenda item was to receive, discuss, and consider for exposure a revision to the proposed P&P Manual amendment to update the definition of an NAIC designation. After the Summer National Meeting, the SVO was directed to consider the actionable comments from industry and to work with industry on further updating and simplifying the definition. Perlman provided an update on these changes.

Perlman said, as mentioned at previous meetings, NAIC designations are currently explained and defined in both Parts One and Two of the P&P Manual. The SVO has proposed consolidating the explanations and definitions into Part One because what constitutes an NAIC Designation is a fundamental policy of the Task Force. In the amendment, the NAIC tried to clarify the meaning of an NAIC Designation, including their use, purpose, and the risks addressed. At the Summer National Meeting, the Task Force and interested parties discussed and provided comments and feedback on that initial draft of the proposal, and the Task Force directed the SVO staff to consider that feedback in a revised version of the amendment. Several of the actionable comments received were incorporated into the amendment being considered for exposure. First, a more concise definition of an NAIC designation that reflects credit quality was created, which also reflects (i) any inconsistencies with the existing regulatory assumption that a fixed-income instrument pays scheduled interest and full repayment of principal on a date certain. This could result in diminution of payment and (ii) where appropriate, loss given default and/or “tail” risk. These last components would likely only be appropriate for certain structured asset classes. Additionally, all references to Subscript S and its application to securities for other non-payment risks was removed.

**Draft Pending Adoption**

Mears directed the SVO to expose the updated definition of an NAIC designation for a 53-day public comment period ending Jan. 26, 2024.

5. Exposed a Revised Proposed P&P Manual Amendment Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the FE Process

Mears said the next agenda item was to receive, discuss, and consider for exposure a revised proposed P&P Manual amendment that would authorize the procedures for the SVO's discretion over NAIC Designations assigned through the FE process. As mentioned during the Summer National Meeting and during the Task Force's the May 15 meeting, the proposal stems from 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 to ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives.

The Task Force received many comments on the initial proposal put forth by the SVO. SVO staff took those recommendations to heart and worked with state insurance regulators to incorporate many of them into this revised proposal. Overall, this was a very deliberative process that state insurance regulators feel is both fair and reasonable, with appropriate levels of feedback and oversight.

It is incredibly important to remember that NAIC designations ultimately fall under the purview of state insurance regulators and are used solely within the insurance regulatory framework. Credit rating providers (CRPs) provide an invaluable service given the number of securities and efficiencies gained by the NAIC. This was demonstrated in the presentation from Perlman and there is no intention of displacing or competing with them. However, because of how the NAIC uses CRP ratings in its processes, this is not an unconditional usage. This proposal is specific to how state insurance regulators, as responsible consumers of CRP ratings for regulatory purposes, choose to use them in that regulatory process. It also empowers the SVO staff to act through a well-defined process, when necessary, in supporting state insurance regulators in this responsibility.

Therriault said the revised amendment incorporates the following process steps, many of which were requested by interested parties:

1) The process starts when an SVO analyst or NAIC regulator identifies as FE security with an NAIC designation assigned by a rating that appears to be an unreasonable assessment of risk.
2) The SVO would then convene the Senior Credit Committee (SCC), composed of the SVO director, the managing investment council, the two credit managers, and four credit supervisors, to meet with the analyst and determine if it agrees that the rating appears to possibly be an unreasonable assessment of risk and, if so, place the security "Under Review."
3) If the SVO SCC votes to put the security "Under Review," an information request will be sent through NAIC systems, such as VISION, to the insurers that hold that security that the SVO needs information on it. If the information request is not responded to, the SVO may reach out to the domiciliary chief financial examiner.
4) Upon receipt of all necessary documentation through the information request, the SVO will then perform a full analysis of the security and coordinate during its analysis with interested insurer(s) on any questions or issues the SVO may have about the security or questions that the insurers may have for the SVO. Insurers are invited to have discussions with the SVO during its analysis to better understand the SVO's analytical concerns and methodology and are able to share their own analytical perspective and methodology.

**Draft Pending Adoption**

5) When that analysis is completed, the SVO SCC reconvenes and determines, based on its full analysis of all necessary information, whether the FE NAIC designation is three or more notches different from the SCC's opinion.
6) If the SVO SCC opinion differs from the FE-produced NAIC designation category by a material three or more notches, the specific CRP rating(s) for that security will be identified for removal from FE and the SVO SCC will present its analysis to a subgroup of the Task Force to provide oversight over the FE removal process and enable the Task Force to provide feedback to the SVO.
7) If there are no alternative CRP ratings, the SVO SCC's assessment will be entered into VISION. If an alternative CRP rating is subsequently received, it will be incorporated into the FE process, if applicable.
8) If the SVO SCC assesses the issue is part of a recurring pattern, the SVO director will inform the chair and decide if an issue paper, referral, amendment, or other action is needed.
9) An anonymized summary of each unique issue or situation will be published on the SVO web page or some other insurer-accessible location for transparency.
10) An insurer may appeal to the Task Force chair if it believes the SVO did not follow the procedures outlined in the P&P Manual. This is an existing instruction that insurers can always avail themselves of.
11) If an insurer(s) wishes to appeal the SVO SCC's analytical assessment, it may request the NAIC's Investment Analysis Office (IAO) to contract, at the insurer's expense, with an independent third-party acceptable to the NAIC IAO to perform a blind review of the security (e.g., without knowledge of the SCC's, insurers', or CRP's assessment) with the information provided through the information request. If the independent third-party review results in an NAIC designation category that is one or less notches different from the FE-produced NAIC designation category, then the SVO SCC's opinion will be overridden by the reinstatement of the CRP rating(s). If the independent third-party review results in an NAIC designation category that is more than one notch different from the FE-produced NAIC designation category, then the SVO SCC's opinion will remain.
12) The SVO will identify through SVO administrative symbols when a CRP rating(s) has been removed from the FE process for a security through its application of discretion.
13) At the Spring National Meeting, the SVO director will summarize FE discretion actions taken for the preceding year.

As a whole, the process outlined reflects many of the recommendations made by Task Force members and interested parties. Specifically, the SVO will have complete information before making an assessment, the Task Force will be involved and informed, the application of discretion only targets a CRP's rating thereby permitting an alternate CRP rating to be used, insurers are invited to have discussions with the SVO during its analysis to better understand the SVO's analytical concerns and methodology and are able to share their own analytical perspective and methodology, there is the ability for insurers to appeal the SVO's analytical opinion to an independent third-party, and the SVO will publish an anonymized summary of issues encountered.

The SVO agrees that credit analysis is both an art and a science; therefore, differences of professional opinion are unavoidable. This proposal focuses on only material differences of opinion. There are additional checks and balances in this proposal that should provide the Task Force and industry comfort that the investment risk assessments are reasonable. Unless otherwise directed to do so by the Executive (EX) Committee and Internal Administration (EX1) Subcommittee, which have the ultimate responsibility for all NAIC fees, the SVO is not planning to propose any fees associated with the discretion analysis other than the potential expense already noted if there is an analytical appeal by insurers to an independent third-party.

Anderson asked how the SVO can determine that something is three notches off where it should be. He also stated that the tests specified presently are unproven in three instances and vague in the fourth instance, noting that the SVO has the authority under the proposal to declare if something is off three notches for any

## Draft Pending Adoption

reason that it feels appropriate. He stated that he does not see in the memorandum from Nov. 3 description of the kind of interaction and information available to insurers called into question. Anderson said if that can be documented with the information available to insurers, it would be very helpful. Anderson's third point was in regard to the appeal process that is new. He said he appreciates the fact that it is being considered and incorporated into this proposal. However, as it is written, it is fraught with problems. First, an appeal can only be mounted if an insurer feels that the SVO has not followed the P&P Manual. Anderson said what is being discussed is whether a rating agency has done a creditable job in rating a security, and the SVO does not necessarily do what rating agencies do.

Mears said there are two different components to making an appeal to the chair or Task Force if any party feels a policy was not followed. Separately, insurers can use the third-party appeal if they do not agree with the analytical assessment, which does not have to be a process-driven appeal.

Anderson said what he was addressing was the third party. The issues with the third party regard confidentiality. He stated that lot of these issues are intended to be private placements. In private placements, the banker, rating agency, and others form deal teams and have confidential information/insiders. Anderson asked how you can find a third party that is eligible and entitled to receive material nonpublic information. A larger problem is that the third party is supposed to act blindly and cannot have access to the other information. Specifically, it cannot have access to the rating agency materials that detail what the rating agency has done. The rational can run from 20–30 pages, and the rating agency is required by the SEC to disclose which of its private methodologies it uses. The third party cannot have access under this proposal. The SVO would have performed its own credit that the third party would not have access to. Under this proposal, the third party will essentially get a stack of virtual documents and will have to figure out the deal all by itself. The SVO will have the benefit of looking at rating agency work but will be coming up with a rating from scratch. Anderson stated that there is a better way of doing this and he hopes the Task Force will consider it. Instead of trying to do a rating from scratch, which would have been done by the rating agency and SVO with guidance from other sources, the third party could evaluate the work of the rating agency, if the confidentiality concerns can be overcome, compare it to the work of the SVO looking at the credit files correspondence, and decide. That would be more likely possible than the idea of coming up with a full-blown rating that will require tremendous research.

John Garrison (Lease-Backed Securities Working Group) said one thing missing from the memorandum is that nothing requires the SVO to produce a report explaining its analytical process to the investor like what is done by rating agencies. Without that, is hard to see how any appeal could be effective without knowing the steps of the analysis. A comment letter addressing that issue will be prepared.

Mears said that has come up in some discussions and that Garrison should absolutely put that in his letter. To provide some initial feedback, Mears said she was initially neutral on the request to have the SVO publish its analysis. However, hearing more about how there was an expectation that insurers would want to use it to distribute amongst themselves made Mears think it would be incredibly problematic to have a written report out there when the NAIC does not have the same engagement letter and provisions that exist for those insurers to demand confidentiality of the process, especially when there are multiple insurers that are invested in a deal and one chooses to reveal that information when others choose not to. That is not a responsibility that the SVO (via the Task Force) can take on, it would end up being problematic.

Therriault said confidentiality is something that the SVO is very concerned about and putting this out in written form to be distributed would be something the SVO is very reluctant to do and would recommend against.

**Draft Pending Adoption**

Having an open discussion with insurers invested in the transaction is welcomed, and the SVO regularly invites them to have an open dialogue.

Mears said there should be no expectation that the insurer will not have full visibility into the analysis that has been done or the methodologies used, and should a have full conversation with the SVO. There is absolute transparency in that process built into this proposal.

Mears, with the permission of the Task Force, directed the SVO to expose the updated amendment authorizing the procedure for the SVO's discretion over NAIC designations assigned through the FE process for a 53-day public comment period ending Jan. 26, 2024.

6. Exposed a Proposed P&P Manual Amendment to Add Practical Expedient to Determine the Issue Date for PLR Filings

Mears said the next item on the agenda was to hear about a proposed P&P Manual amendment to add a practical expedient to determine the issue date of private letter rating (PLR) filings.

Therriault said the SVO has been unable to independently source the date attribute "issue date" (e.g. date of legal closing), a necessary input to determine the requirement to provide a PLR rationale report. The SVO proposes permitting it to apply a practical expedient by assuming that any security subject to PLR guidance that was acquired on or after Jan. 1, 2022, was issued on or after Jan. 1, 2022, unless documentation showing an earlier issue date is provided. This is to fill in the gap that exists in the current data.

Michael Reis (Northwestern Mutual, representing the American Council of Life Insurers [ACLI], the Private Placement Investors Association [PPiA], and the North American Securities Valuation Association [NASVA]), said there has been a back and forth with PPiA, NASVA, and ACLI companies that may relate to the same root cause of what the exposure is about or even an ancillary issue related to it. The groups are fine with the exposure date but would like to meet with the SVO to talk about some the concerns.

Therriault said the SVO is always happy to meet with industry, work through any operational details, and propose modifications if something is needed to clarify an issue.

Mears said if there are any operational questions or needed guidance on how to interpret something, it can be posted on the SVO or Task Force web page.

Mears, with permission of the Task Force, directed the SVO to expose the proposed amendment to add a practical expedient to determine the issue date of PLR filings for a 53-day public comment period ending Jan. 26, 2024.

7. Received a Staff Report on Updates on the Proposed CLO Modeling Methodology Ad Hoc Group

Mears said the next agenda item was to hear updates on the proposed CLO Modeling Methodology Ad Hoc Group.

Eric Kolchinsky (NAIC) said the CLO project is proceeding apace. Recently, the SSG proposed 10 scenarios, including a number in the tail of the probability distribution. The detail was posted for default rates and recoveries for each scenario on the CLO web page.

 

**Draft Pending Adoption**

The SSG also posted cash flow results for each proxy deal. The next step is to set probabilities for each of the 10 scenarios based on these cash flows. The SSG is looking for industry feedback on these probabilities.

Kolchinsky also said based on the Risk-Based Capital Investment Risk and Evaluation (E) Working Group's work, the SSG views the current approach to be consistent with the American Academy of Actuaries (Academy) principles that were discussed. The SSG offers assistance to the Working Group or Academy on any work that may be required on CLOs or any other structured product.

Kolchinsky then said he would like to address two operational issues that have come up. First is the starting date for the project, which is 2024. To clarify, nothing operational happens Jan. 1. The first impact will occur at year-end 2024 when the results are released. Second, just in case this work gets slowed down, there is an option to extend the effective date to 2025. This possibility was anticipated at the start of the project. If the extension is required, the Task Force will be informed at the Spring National Meeting, and an amendment to the P&P Manual to replace 2024 with 2025 can be submitted for the Task Force's consideration at the Summer National Meeting.

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

Mears said the next item on the agenda was to hear updates on the projects of the Statutory Accounting Principles (E) Working Group.

Julie Gann (NAIC) said this is an update in accordance with the coordination initiative with the Statutory Accounting Principles (E) Working Group. The Working Group met Dec. 1, 2023. Gann said that for all actions, please refer to the full summary and the minutes, as this will just be a high-level subset of investment-related items that may be of interest to the Task Force. The Working Group adopted three items. First, regarding residual interests, in the interim, there were adopted revisions to *SSAP No. 43R—Loan-Backed and Structured Securities*, *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*, and the annual statement instructions to make it clear that all in-substance residuals shall be reported on Schedule BA. At this national meeting, the Working Group incorporated revisions to *SSAP No. 30R—Unaffiliated Common Stock* and *SSAP No. 32R—Preferred Stock* to make it clear that all in-substance residuals should be recorded on Schedule BA. That is effective immediately for year-end 2023. Hopefully, it is very clear that if an investment is an in-substance residual, it needs to be on the Schedule BA reporting line as a residual.

Second, the Working Group adopted revisions to S*SAP No. 2R—Cash, Cash Equivalent, Drafts and Short-Term Investments* to further restrict the investments that are permitted for cash equivalent and short-term reporting, with an effective date of Jan. 1, 2025. As a reminder under the bond project, the Working Group adopted revisions to remove all ABS from that short-term schedule. With ABS, the items that were just restricted include mortgage loans and all Schedule BA items, including collateral loans.

Third, the Working Group adopted revisions to the annual statement instructions to address specific elements related to interest maintenance reserve (IMR) that will allow non-interest-related impacts to got to IMR instead of asset valuation reserve (AVR), with an effective date of Jan. 1, 2024. Those focus mostly on mortgage loans and debt securities with known credit events that have occurred, but the rating or designation has yet to be updated before it is sold by a company.

There are six exposures to be addressed. First is the exposed revisions to *SSAP No. 21R—Other Admitted Assets* to incorporate a new measurement method for residuals. This included comments received from industry on the incorporation of the "effective yield with a cap" method but also has a practical expedient to allow the "cost recovery" method, which was the approach exposed previously by the Working Group. This exposure

**Draft Pending Adoption**

also includes the guidance for non-bond debt securities and is part of the bond project exposures. However, there were no comments on that section from the last exposure so there are no revisions to it. This is exposed until Jan. 22, 2024, and will hopefully be adopted in early February so the Schedule BA revisions can be adopted in February. That will conclude all the revisions for the bond project. They are posted publicly on the Working Group web page.

The Working Group exposed reporting revisions for collateral loans on Schedule BA. There had been a lot of conversations with regard to collateral loans earlier this year clarifying the guidance for admittance. The reporting was not sufficient to identify the underline collateral for collateral loans, so that is reflected in exposure with the Jan. 22, 2024, deadline to include several more reporting lines to bucket collateral loans. It also requests comments regarding possibly consolidating some of those lines.

Also exposed were reporting revisions to Schedule BA to further expand the description of the different types of underline components for the SSAP No. 48 items, such as fixed-income instruments, common stock, and real estate, to make sure everyone did the same descriptions for which investments were reported in each category for the Jan. 22 deadline.

There is a proposal to reject the "current expected credit loss" U.S. generally accepted accounting principles (GAAP) standard, otherwise known as current expected credit losses (CECL). The current exposure is for a full rejection of the CECL guidance.

The Working Group exposed revisions to IMR related to perpetual preferred stock reported at fair value. That measurement change was incorporated in 2021. The Working Group has not updated the current IMR guidance that refers to perpetual preferred stock. These revisions serve to correct the current disconnect in the guidance.

Lastly, the Working Group exposed significant SSAP revisions *to SSAP No. 93—Low-Income Housing Tax Credit Property Investments* and *SSAP No. 94—Transferable and Non-Transferable State Tax Credits* pertaining to investments that generate tax credits and acquired tax credits. This exposure expands that guidance and specifically asks for comments on impacts that should be considered for the Schedule BA reporting lines beyond the current Low-Income Housing Tax Credit (LIHTC) guidance.

9. <u>Received Notification from the SVO that it Will Defer the Deactivation of PLR that Missed a Required PR Rational Report Until Year-End 2024 and Requested Insurers to Submit Their Reports</u>

Mears said she believed that Therriault had one other matter related to the deactivation of private ratings that are missing a required rationale report for year-end.

Therriault said it is taking the NAIC longer than expected to make the necessary updates to associate PLRs to the private rating rationale reports. Additional testing is still needed, and the SVO will be deferring the deactivation of PLRs that do not have a required rationale report until year-end 2024. The SVO wants to be certain this process is working accurately and does not want to unnecessarily penalize any insurer by deactivating a private rating at year-end. If the SVO has received a private rating letter in 2023, it will be reflected in the AVS+ application for year-end. Insurers should continue to submit rationale reports to the SVO. While private ratings will not be deactivated, insurers should not use this as an opportunity to avoid filing the rationale report with the SVO. The initial assessment is that private ratings have significantly increased for 2023. Through Nov. 30, there are approximately 7,327 private ratings that translate into an NAIC Designation, which may include some 2022 PLRs. There are some 2,430-private rating rationale reports missing, and the

 

**Draft Pending Adoption**

related private rating would have been deactivated if the SVO was not deferring the deactivation process for year-end 2023. That number of missing rationale reports excludes securities that are missing an issue date, the problem discussed earlier, or those issued prior to 2018. Again, the SVO requests insurers submit complete information, including the required private rating rationale reports. The SVO will continue to test NAIC systems in 2024.

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-12-01 Fall NM/Minutes/VOSTF_2023-12-02_Fall_NM_Minutes (FINAL).docx