VALUATION OF SECURITIES (E) TASK FORCE

Valuation of Securities (E) Task Force February 21, 2023, Interim Meeting Minutes (Attachment One)
Valuation of Securities (E) Task Force 2022 Fall National Meeting Minutes (Attachment Two)

Draft Pending Adoption

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 Reese (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.

Draft Pending Adoption

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.

Reese 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." Reese 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 Reese 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 Reese, 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.

Draft Pending Adoption

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. Discussed Next Steps for the CLO Modeling Project

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:

Draft Pending Adoption

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

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

Draft Pending Adoption

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

Draft Pending Adoption

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.

Reese 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/2023/2023-03-23 Spring NM/Minutes/VOSTF 3.23.23 Spring NM Minutes (v5 FINAL).docx

Draft: 3/9/2023

Valuation of Securities (E) Task Force
Virtual Meeting
February 21, 2023

The Valuation of Securities (E) Task Force met Feb. 21, 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 Ray Spudeck (FL); Dana Popish Severinghaus represented by Vincent Tsang (IL); Vicki Schmidt represented by Tish Becker (KS); Kathleen A. Birrane represented by Matt Kozak (MD); Gary D. Anderson represented by John Turchi (MA); Grace Arnold represented by Ben Slutsker (MN); Chlora Lindley-Myers represented by Debbie Doggett (MO); Marlene Caride represented by John Sirovetz (NJ); Adrienne A. Harris represented by Jim Everett (NY); Glen Mulready represented by Holly Mills (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. Adopted a P&P Manual Amendment to Update References to 5GI

Mears said the first item is to consider adoption of a non-substantive proposed *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) amendment to update references to 5GI. This proposed amendment was exposed for a 60-day comment period that ended Feb. 13. One comment letter was received from the American Council of Life Insurers (ACLI).

Marc Perlman (NAIC) said that at the 2021 Fall National Meeting, the Task Force adopted a non-substantive technical amendment to the Private Letter (PL) Securities section in Part Three of the P&P Manual, which clarified that an NAIC 5GI designation is the equivalent of an NAIC 5.B designation category. The Securities Valuation Office (SVO) identified other places in the P&P Manual where the 5GI.B designation category was not specified and proposed a non-substantive technical amendment to make those clarifying changes. The SVO recommends that these changes be adopted.

Mike Reese (Northwestern Mutual representing the ACLI, North American Securities Valuation Association (NASVA), and Private Placements Investors Association (PPiA)) said they are supportive of the proposed amendment.

Doggett made a motion, seconded by Clements, to adopt the P&P Manual amendment to update references to 5GI (Attachment). The motion passed unanimously.

2. Adopted a P&P Manual Amendment to Add Instructions for the Financial Modeling of CLOs

Mears said the next item is to discuss comments and consider for adoption an updated proposed amendment to the P&P Manual to include collateralized loan obligations (CLOs) as a financially modeled security in Part Four. At the 2022 Fall National Meeting, the Task Force directed Investment Analysis Office (IAO) staff to update the amendment to take into consideration the technical recommendations in the ACLI's comment letter, and then re-expose the amendment for a 15-day comment period that ended Jan. 9, 2023. One comment letter was received from the ACLI.

Charles Therriault (NAIC) said this amendment would add CLOs within the scope of financially modeled securities in Part Four of the P&P Manual.

Like the current residential mortgage-backed securities (RMBS)/commercial mortgage-backed securities (CMBS) project, the NAIC will almost exclusively perform surveillance work for CLOs. While the Structured Securities Group (SSG) may be asked to perform some regulatory treatment analysis services (RTAS) on new issue mandates, these are expected to be extremely rare. Surveillance requires significantly less effort and will only be done once a year, along the same schedule as other financially modeled securities that the SSG already models. The actions proposed in the amendment are designed to allow insurers to continue participating in the CLO market without the risk that aggressive structuring puts policyholders and insurer investments in jeopardy.

Two comment letters were received from the ACLI. The ACLI made several constructive technical suggestions in the first comment, which the IAO substantially incorporated into the updated proposed amendment. The second comment letter, dated Jan. 9, asked about the intent of the note in the amendment stating that it was effective as of Jan. 1, 2024. The purpose of this note is to establish when the SSG is authorized to begin modeling CLO investments and provide insurers sufficient notice of this change. It is expected that insurers will follow the existing limited filing exemption (FE) for RMBS and CMBS in Part Four, paragraphs 4–5, for interim reporting. These paragraphs permit securities that cannot be financially modeled, which would be the case for CLOs until the SSG produces its first modeling output for them but are rated by a credit rating provider (CRP), to use that CRP rating to determine the NAIC designation that would be applicable under the FE procedure. Once the security is financially modeled, this limited exemption would no longer apply because it would then be a "financially modeled" security. The SVO did notice that some section titles in the amendment did not include "CLO," but the detailed instructions within that section did. With the Task Force's approval, the SVO will make those technical corrections to the final amendment.

Steve Clayburn (ACLI) thanked the Task Force for taking the concerns and suggestions in the comment letter into consideration and explaining the plan with regards to the Jan. 1, 2024, effective date and interim reporting.

Mears noted that the adoption of this finalized amendment would formalize the motion the Task Force adopted at the 2022 Fall National Meeting authorizing SSG staff to take on the CLO analytical function and request the resources it may need.

Stolte made a motion, seconded by Spudeck, to adopt the P&P Manual amendment to include CLOs as a financially modeled security in Part Four with an effective date of Jan. 1, 2024, with the technical corrections noted by Therriault. The motion passed unanimously.

3. Discussed an SSG Memorandum on a Proposed CLO Modeling Methodology (Excluding Scenarios and Probabilities)

Mears said the next item on the agenda is to hear comments on the SSG memorandum on a proposed CLO modeling methodology (excluding scenarios and probabilities). The modeling methodology was exposed for a 60-day comment period that was scheduled to end Feb. 13, but it was extended, at industry's request, to Feb. 17. The Task Force will be working through the substance of the details in those comments but will use this

opportunity to have the interested parties that wrote comment letters speak, allowing immediate questions and responses so that a dialog can take place to establish next steps. Comment letters were received from:

- ACLI
- American Academy of Actuaries (Academy)
- PineBridge Investments
- Equitable, MetLife, New York Life Insurance Company, Northwestern Mutual, Pacific Life Insurance Company, Prudential Financial, and Western & Southern Financial Group (sent jointly)
- Athene, Everlake Life Insurance Company, F&G Annuities & Life, Global Atlantic Financial Group, and Security Benefit Life Insurance Company (sent jointly)
- American Investment Council
- Structured Finance Association

According to the Task Force's website, "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."

As noted several times, it is not under the purview of the Task Force to establish actual risk-based capital (RBC) factors, and there is an initiative underway by the RBC group to address that. It is also not under the purview of the Task Force to determine statutory accounting. That would be under the purview of Statutory Accounting Principles (E) Working Group. However, it is under the purview of this Task Force to establish the credit assessment procedures and finding areas of focus that may end up involving some of those other regulatory groups. Each group has its own unique area of responsibility and expertise that the NAIC utilizes along with interdependencies between the groups.

It has been said multiple times, but it bears repeating, the SVO and SSG are not rating agencies. The Task Force has required them to provide these designations on an annual basis for use in the year-end financial statements for use by regulators in establishing RBC results, in quality assessments, and they are used in some state law provisions. The Task Force does not require them to follow the requirements imposed by the Credit Agency Reform Act, which would apply to nationally recognized statistical rating organizations (NRSROs) who take a different view in terms of an overarching surveillance process and not the annual review that is used for this narrow provision for regulators. While the Task Force relies on the SVO and SSG, there are times when it feels it is appropriate to effectively outsource that review to NRSRO when the results will be consistent with what the Task Force expects moving all the way through the NAIC framework. As noted for the CLOs, the Task Force has identified an instance where it does not feel that the existing process works throughout the entire NAIC framework. The Task Force is assessing the modeling piece for credit assessment of CLOs. The RBC assessment is being looked at by the Risk-Based Capital Investment Risk and Evaluation (E) Working Group and the groups are being collaborative with one another.

Eric Kolchinsky (NAIC) said due to the late nature of the responses, there has not been an opportunity to respond in writing yet but there will be one. Some of the comments were not responsive to the methodology, but instead just discussed the modeling process itself. One of the comments by the interested parties compared the resources at a rating agency, which rates new deals, to what the SSG does, which is a very simple surveillance process. Having previously co-managed what was called the Global Derivatives Group at Moody's Investors Service (Moody's), which included CLOs, collateralized debt obligations (CDOs), and similar products and knowing the resources

needed for this product, the SSG is not trying to build a new issue platform, but rather a surveillance process, for which there are adequate resources. As with the current RMBS/CMBS project, the SSG does not expect to analyze any new issues. There is an RTAS process in case that is required, but the SSG currently does at most one every year. The backlog that was mentioned by one of the commenters had to do with new issue process, not surveillance. Lastly, resources are not a theoretical question. The SSG currently runs all the insurance company CLO holdings annually without any extra resources. As the regulators participating in this meeting know, the SSG produces bond-level results for them to use and put up on the Tableau worksheet. This is easily doable going forward with extra resources.

Overall, there were a lot of miscellaneous textual comments or questions. Most were very good and will included in responses in terms of detail and working through those issues in the future. The main issue that came up multiple times is that of prepayments and reinvestments. This is going to be the main issue for us working through the methodology. Prepayments are not material, but they do influence two other assumptions in the modeling: having the use of principal to pay overcollateralization (OC) tests, and, much more importantly, the par building process that is sometimes assumed. Using principal proceeds to cure OC tests is extremely expensive. Thinking about the total cost of funds for the deal, it is not expected to be used. The managers have a lot of options not to be used and do not think that is a controversial position. All that it does is switch the risk from the top to the bottom if using principal proceeds. The main issue up for discussion going forward in terms of scenarios is going to be reinvestment. Having prepayments allows principal proceeds, which can be reinvested, and if reinvested at a below par price, then par can build up. That annual ongoing par build allows the offset losses in the modeling. For example, if 20% of the portfolio repays, then take that 20%, and reinvest in something trading at a dollar price over 0.99, then there is more par and that offset approximately 0.2 times 0.1 losses in the modeling. There is some historical precedent to this, as there was a lot of par building by CLOs in the global financial crisis and during the coronavirus pandemic, and it did work out well. Part of the reason it worked out well is because of the Federal Reserve's interventions in the market, which stabilized pricing on risky assets and pushed those prices up, allowing managers to build a par and maintain a safer portfolio. It is not clear whether that assumption should continue.

It is also important to remember, for those of who were there in the past, that the process of buying securities at a discount was the death knell of the collateralized bond obligation (CBO), which was the main product before the CLO. Post the dot-com bubble, reinvested at a discount price created a downward spiral and CBOs have never recovered. This is not a universally positive thing. The SSG is not aware of any rating agency modeling these discounted purchases to build up par. If that is incorrect, the SSG requests that interested parties provide references to public NRSRO criteria that allow it to do that. The SSG's understanding is that it is not something that is modeled for by rating agencies. Next, active management is not to CLOs, so it is something that could theoretically be applied to any active pool, whether it is loans or bonds, but that was not assumed in the modeling for RBC C-1 factors. This is not something that differentiates CLOs from the standard of active management and it is unknown why it would be applied there in the first place. Lastly, Kolchinsky said that he personally has a strong conviction against this par-building mechanic based on his prior experience with CBOs and the dot-com bubble. However, part of the ACLI proposal is only to have it in certain scenarios and he is willing to explore that potentially with interested parties.

Outside of these two issues is primarily that of reinvestment and the assumption that proceeds are reinvested. This will require a greater focus on the reinvestment type assumptions: what rating, what maturity, callable schedule, etc. One of the reasons the SSG proposed a no-reinvestment assumption is because it is simpler. It does not try to overfit the model and is a very simple assumption. Again, it is stylistically better but it can be opened if there are good reasons to do so if it does not overfit the model.

Recall that the main constraint here is the reporting equivalency between a pool of loans and the sum of all the tranches. To that extent, no matter what is discussed in terms of reinvestment assumptions, certainly, the only thing it could do is sort of shift between various tranches and risk levels within the CLO, not necessarily improve CLO performance. There is a limited usefulness of these assumptions, but again SGG is open to discussing them once the process starts going.

Lastly, Kolchinsky said there was one very reasonable comment to release all the assumptions for modeling. This has not been done because the SSG has not written the assumptions. There has been one main constraint, which is reporting equivalency. How to accomplish that is something the SSG will want to work with interested parties on. With the reporting equivalency, the SSG will continue to work with the Risk-Based Capital Investment Risk and Evaluation (E) Working Group to make sure the view of reporting equivalency is consistent. It is a process working in parallel with that Working Group and continuing communication with them.

To keep this process going and ensure transparency, the SSG would like to ask the Task Force to form an ad hoc group to model deals. The discussion so far has been about theoretics, though, at some point the idea is to nail down as much of those theoretics as possible. At the end of the day, it is going to come down to transactions and looking at those transactions and how the scenarios impact them. Making sure that is effective requires a small number of active participants going back and forth with information. Interested parties are asked to form coalitions, or at least groups, that have a single voice and can take information back to their participants. Once this process is formalized, SSG can begin looking at actual transactions and modelling actual transactions with some of these modifications and without some of the modifications so there are numbers for people to compare.

Mears said there was a lot of information to digest. As a reminder, the Task Force is not taking any actions today and will discuss the ad hoc group after hearing from interested parties on their comment letters. Everett asked if regulators can be part of the ad hoc group as well, to which Kolchinsky replied absolutely.

Clayburn said he is intrigued by the suggestion for an ad hoc group and the ACLI gives a thumbs up on that. The ACLI appreciates the fact that it was allowed to comment, and the overriding thoughts are that the assumptions should not be simplified and should be able to reflect the economic conditions of each point in time in the scenarios that are ultimately developed. The exposed methodology assumes that the non-defaulting portion of each loan matures based on the legal maturity. While commercially available models may have limitations with projecting every possible cash flow scenario, the ACLI recommends that, where practical and reasonable, modeling assumptions should capture loan features such as amortization and callability. Proposed in the letter is to replace no prepayments assumed with prepayment assumptions that vary by scenario and through time within the scenario. A chart was provided that outlines some of those scenarios for the Task Force and the SSG to consider. The letter also proposed replacing reinvestment collateral as purchased at par with pricing levels that vary by scenario and term and included a chart for which to begin the discussion. This was answered on the Task Force's last agenda item. Expected frequency of the designation modeling will be done once a year but ACLI suggests that maybe it could be done more frequently than annually.

As for assigning ratings to underlying assets, the ACLI proposes replacing the fallback assumption that uses the SVO-assigned NAIC designation category with more transparent assumption logic that all parties can instantly use because not everyone has availability to the NAIC designations. The letter suggested using the fallback logic that had been used for reinvestment assumptions that is assigned the weighted average rating factor, or, if not reported, assume it to be, for example, 4.B, which is a B3 or B rating. As for callability of bonds, CLO transactions typically include call provisions that are frequently exercised when market conditions make it economically advantageous. The ACLI suggests considering whether modeling call features would be impactful to the loss projections under the proposed modeling framework, and if so, to evaluate ways of incorporating this feature in the modeling exercise.

Kolchinsky said loans with an amortization schedule, if available, are easy to work on and non-controversial. The things with calls, both on the loans and the tranches where there's optionality, they are just difficult to model but SSG is very much open to seeing how that works out. In terms of the annual frequency, that is the official frequent but SSG will endeavor to do unofficial ones as often as possible. The goal is to work on a detailed process that everyone knows and that is predictable. It is very important that everyone sees what is going on. Currently, what is run is the latest portfolio, as available in trustee reports, running through methodology in batches, as resources allow.

Mears said the intent once this is complete is that the methodology and scenarios are transparent enough that any user who has access to a modeling framework platform should be able to do it on their own, like a one-by-one deal. Kolchinsky said the hope is that most of the participants who responded and are sophisticated modelers should be able to replicate what the SSG is doing and provide feedback.

Steve Smith (Academy) said Kolchinsky has been transparent and engaging throughout working through the process. The comment really is more of a process-oriented comment. The Academy has been engaged with the Risk-Based Capital Investment Risk and Evaluation (E) Working Group and helping them think through CLO capital. This has involved higher-level, more conceptual issues such as what the statistical safety level should be, how it should think about the concept of RBC arbitrage, etc. As the Risk-Based Capital Investment Risk and Evaluation (E) Working Group works through those problem, they will form the basis for the objectives of any model that would then be built to assign NAIC designations to CLOs, recognizing that it's difficult to disentangle NAIC designations from RBC from C1. The comment is to acknowledge that the Academy finds it difficult to comment on any methodology to a model before the Academy knows what the objectives are. It is premature to be getting into too detailed a conversation on model methodology.

Kolchinsky said it has been great working with the Academy. It has been a mutually great relationship going back and forth. He said the goal is that RBC is the target, and the SSG works on how to reach the target. Kolchinsky said whatever targets may be provided, the SSG is happy to adjust to those.

Mears said the PineBridge Investments comment letter talks about what time frames to look out for some of the data that is being used. PineBridge Investments believes pre-2000 data is not necessarily relevant. It also points to the fact that the NAIC uses Moody's default data and recommends looking more at the Morningstar LSTA US Leveraged Loan Index. There are some other technical comments on recovery rates. Another comment is that since this is starting with CLOs, is it unfairly penalizing CLOs by going through this process that has not yet been done for other types of securitized transactions that may exhibit similar features. This is being done because there is more information on CLOs, and it is a place to start. That will take time and it is an important consideration to work through as the Task Force looks at the overall structured securities universe over time.

Kolchinsky said CLOs are clearest. One always needs to start somewhere. If the Task Force asks the IAO to look at other types, it is happy to assist. As for Morningstar LSTA versus Moody's, Moody's was used to calibrate the defaults for risk-based capital C-1 factors, so it is a consistent apples-to-apples comparison. Mears said this will go back for consideration, too, as work proceeds with the Academy.

Christopher Halldorson (Prudential Financial) said the firms listed in this letter all purchase CLOs and are strongly in support of the NAIC initiative. The firms believe the initiative is going to generate capital requirements that are transparent, consistent across asset classes, appropriately calibrated for tail risks, and designed to minimize capital arbitrage incentives. Highlighting a couple of items for consideration just because they are out there in the ether, some of them have not necessarily been brought up so far. CLOs represent a material risk to U.S. life

insurers. That is because of the growth rate versus general accounts, the significant allocations within certain firms, and the fact that insurers are a material capital source for CLOs, in general. By some accounts, insures look like they are 50% of the mezzanine capital source. And finally, just one other point is that CLOs represent about 3–4% of life insurance holdings. That might sound small, but it is also the size that CMBS was in 2006. It is hard to look back and say that more transparency would not have been wanted in the system.

The firms on the joint letter 100% believe the SVO has the in-house modeling capabilities to appropriately model CLO for this purpose. The third-party model, transparency, stresses, and parameters used will all mean that it can be replicated. Some insurers have replicated the annual NAIC Capital Markets Bureau studies and have gotten very similar results. There may be disagreements on inputs to those stress tests but can get to the same results. This transparency is needed.

The IAO is not trying to become a rating agency and is just trying to perform a function that the rating agencies are not designed for. Rating agencies do not rate credits to the 96th percentile standard that the risk-based capital C-1 factor is designed. This is trying to fill a gap that exists. In terms of capital arbitrage, our firms interpret the no-arbitrage principle as an effort to ensure consistent capital treatment across asset classes and structured tranches. All regulators and industry participants should support that goal.

There should be caution around how one thinks about active management and diversification when getting into tail events. Most leveraged loans are financed through CLOs, so one would have to assume certain CLO managers are outperforming each other, which is a hard thing for the NAIC to do. Also on the diversification front, current C-1 bond factors incorporate the diversification of about 800 mostly investment grade issuers. The typical CLO has 200 or less issuers and mostly high yield. One must be careful about over ascribing diversification to one without looking at it in conjunction with the other. There is a lot of discussion surrounding experience on CLOs and how an experience on a BBB CLO or a BB CLO versus corporate bonds. CLO tranches are designed to have different loss experience relative to corporate bonds. This is by design; it is not good or bad. CLOs have a first loss protection built in, which is there to absorb collateral defaults when they are low. They also have embedded leverage, which can drive material losses when collateral defaults are high. This cliff risk, which the Academy described in its report, is driven primarily by systemic credit downturns, not by idiosyncratic or a few issuers' default. A systemic credit downturn has not been seen to the extent that insurers have held capital for corporate bonds over the past 20 years. That is when insurance companies have had CLOs. Extrapolating the very specific market conditions over the past 20 years that has been had for CLOs is not going to be a sufficient answer to meet RBC standards for corporate bonds held right now. Just as a reminder, the current C-1 bond factor is recalibrated using almost 40 years of default and loss experience. There is no reason to delay this work and there should be some urgency on this moving forward. CLOs should be the easiest structured asset class to model, understand, and provide consistent capital treatment and transparency to regulators.

Kimberly Welsh (Athene) said the firms included on the comment letter believe that any review must be data driven, nondiscriminatory, and result in asset capital charges that align with the risk across all asset classes. A concept called equal capital for equal risk in the letter. The firms are arguing for the appropriate amount of capital for development risk, not necessarily less capital, and believe all asset classes should be modeled and evaluated using the equivalent assumptions and methodologies. Consistency across risk and asset classes, and curve and appropriate allocation of capital and avoid inappropriate concentration from certain risks. It is unclear as to why senior secured loans are vulnerable to be knocked down only within the CLO. The approach in the comment letter is consistent with the NAIC's long-standing class process of data-driven and nondiscriminatory regulations.

Welsh agreed with the NAIC that capital target for CLOs needs to be calibrated and thinks that if the analysis is performed on a bottom-up basis with consistent assumptions across asset charges, it will be determined that capital charges for CLOs rated investment grade will be lower than those for equivalently rated corporate debt. There is no shortage of data and studies that track the performance of CLOs, showing that they performed better and have less risk than equivalently rated corporate bonds. But beyond performance, a recent paper by Professor Robert A. Jarrow from Cornell University concluded that CLO tranche loss probabilities are, on average lower than comparably rated corporate debt. A discussion in the Academy and a recent white paper on structured debt are linked in the submission and should be considered as well.

Welsh said Kolchinsky responded to some of the concerns raised in the letter about the current ability for the SSG to dynamically model CLOs. There may be a need for more clarity on that. It is a heavy lift, and the NAIC is encouraged to more extensively evaluate the gaps in the current analysis and service of the credit reporting providers, which could be helpful in this process. Also, the letter provides technical feedback on the stress test methodology. It is difficult to provide complete feedback without understanding the full scope of the proposed changes and without certain plans for that. It would be helpful to back test the analysis and impact analysis of filing exempt (FE) ratings mapped to intrinsic price.

Mears said that this process began not quite a year ago and introduced the concept. At the time, it was within an existing RBC and designation framework and considered a different way to map those to those existing categories. This is how the concept of RBC arbitrage came up. Since then, it has been said multiple times that is not a reflection on the CLOs themselves. CLOs are not arbitrage type investments. The RBC group has since picked up reviewing the overall capital charges in general. This would effectively solve for that capital arbitrage to Smith's point earlier, as there would be something to calibrate and map to that makes sense. The comments are appreciated but to some extent they may be somewhat dated with this presumption that it would result in punitive capital charges for CLOs. That is not part of the methodology. The idea of the very highly rated CLOs having perhaps lower capital charges than corporate bonds has been on the table for a while and would likely come out of the RBC process, where ultimately that will reside. Additional commentary on this is better placed with the RBC group.

Kolchinsky said he did not have a view of the final outcome and did not want to prejudice the process. It may be possible that mezzanine AAA and AA rated tranches get a little more capital charge on this framework. Knowing the results would require knowing the probabilities, which is something that will be worked out in this ad hoc group. The overall constraint is reporting equivalency. Back testing is something that would apply to a black box model, but since this is going to be transparent, each company can run the back testing however they want. Back testing is done on a closed model to see how it does as proof and all the companies that do that work as part of the analysis.

Welsh said the second part was impact analysis. Kolchinsky said absolutely, and that as the stress tests are run, the process for stress test analysis is there. The idea is transparency so that everyone can do it and if something comes up, and it would be shared. To clarify the notching leveraged loans in the CLOs, mentioned in the technical comments, is only the rating on the loan if there is no issuer rating or no corporate rating. Those need to be mapped to default probabilities. It is very similar to what rating agencies do to take the default probability, because the rating on the loan itself, the issue rating incorporates recovery assumptions as well. There is no penalty for leveraged loans; rather, the default probability is extrapolated, similar to what is done by rating agencies.

Mears said there were quite a few technical comments that can be taken into consideration as well as other broader comments that have been addressed in this discussion already. If something has not been addressed, it will be as the comments are reviewed.

Dallin Merrill (Structured Finance Association (SFA)) said substantively, most of the comments are from issues that have already been raised. The SFA does strive for consensus in two areas. Firstly, in eliminating capital arbitrage and supporting the NAIC and the regulators in that. Secondly, on the need for fleshing out the modeling assumptions in the scenarios. The SFA would be interested in any working groups that form to help advance that work so the modeling assumptions can be made clear.

Mears directed Kolchinsky to coordinate the creation of this ad hoc group. Task Force members can participate as they would like. For this to be a very efficient group, representatives should have the technical expertise to really work through some of these modeling processes. Additionally, the coalitions that are formed in the trade groups can put forth one person to be the communication point back to their group. Full representation is wanted, as there are some varying opinions on some of these topics, and so that the persons involved are actively engaged, and in tune with the conversations.

The modeling process is on the SSG website and not in the P&P Manual. As changes are made, they would be communicated back to this group and published on the website. The methodologies are not adopted. Once there is something that everyone can wrap their arms around, direction would be provided to continue to move forward with that methodology. For those not participating in the ad hoc group, please remain engaged with your various counterparts. The Task Force will continue to be transparent with this group about changes to that process.

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-02-21 Interim Meeting/Minutes/VOSTF 02.21.2023 Minutes v5 - (FINAL).docx

Draft: 1/3/2023

Valuation of Securities (E) Task Force
Tampa, Florida
December 14, 2022

The Valuation of Securities (E) Task Force met in Tampa, FL, Dec. 14, 2022. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Scott A. White, Vice Chair, represented by Doug Stolte and Greg Chew (VA); Evan G. Daniels represented by David Lee; Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone and Wanchin Chou (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Virginia Christy (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); Chlora Lindley-Myers represented by Debbie Doggett (MO); Eric Dunning represented by Lindsay Crawford (NE); Marlene Caride represented by John Sirovetz (NJ); Adrienne A. Harris represented by Bob Kasinow and Jim Everett (NY); Cassie Brown represented by Amy Garcia (TX); and Mike Kreidler represented by Steve Drutz (WA). Also participating was: Tom Botsko (OH).

1. Adopted its October 20 and Summer National Meeting Minutes

Mears said the first item is to consider adoption of the Task Force's Oct. 20 and Summer National Meeting minutes. During its Oct. 20 meeting, the Task Force took the following action: adopted its 2023 proposed charges; 2) discussed and exposed a proposed *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) amendment to add instructions for the financial modeling of collateralized loan obligations (CLOs); 3) discussed and exposed a proposed P&P Manual amendment to update instructions for related party and subsidiary, controlled, and affiliated (SCA) investments; and 4) discussed and exposed a proposed P&P Manual amendment to clarify the definition of an NAIC Designation in Part One and Part Two of the P&P Manual.

Stolte made a motion, seconded by Kozak, to adopt the Task Force's Oct. 20 (Attachment One) and April 5 (*see NAIC Proceedings – Summer 2022, Valuation of Securities (E) Task Force*) minutes. The motion passed unanimously.

2. Exposed an Updated Proposed Amendment to the P&P Manual to Include CLOs as a Financially Model Security in Part Four

Mears said the next item is to discuss comments for a proposed amendment to the P&P Manual to include CLOs as a financially modeled security in Part Four.

Eric Kolchinsky (NAIC) said the proposed amendment would add CLOs, a type of structured security backed by a pool of debt with corporate loans of very low ratings within the scope of financially modelled securities in Part Four of the P&P Manual. It is NAIC staff's opinion that an insurer that purchases every tranche of a CLO holds the exact same investment risk as it would if it had directly purchased the entire pool of loans backing the CLO. Like the current residential mortgage-backed securities (RMBS)/commercial mortgage-back securities (CMBS) project, the NAIC would almost exclusively perform surveillance work for CLOs and be asked to perform some regulatory treatment analysis services (RTAS), which is the full-on initial analysis of a deal, but this is not expected often. Hence, there will be a lot less effort than what would normally be required by a rating agency. This would also be performed once a year, similar to the RMBS/CMBS project, which is primarily yearend.

The Investment Analysis Office (IAO) recognizes the importance of CLOs to the financial markets, and this amendment does not diminish the role of insurance companies and their investments in the U.S. economy and financial markets. Nevertheless, the main priority of state insurance regulation are policyholders and ensuring that they are protected through prudent financial solvency policies. The actions contemplated are designed to allow insurers to continue participating in the CLO market without the risk that aggressive structuring puts policyholders and insurance investments in jeopardy. One comment letter was received from the American Council of Life Insurers (ACLI). It made several constructive technical suggestions. The IAO staff requests the Task Force defer adopting the amendment today to permit the amendment to be updated with most of those recommended changes. An effective date of Jan. 1, 2024, for the change is recommended with the first reporting year-end being Dec. 31, 2024. That will provide sufficient time to develop the scenarios and methodology and report back to the Task Force, as well as using 2024 to give insurers information about what the results would be at year-end. A brief 15-day comment period is requested for this re-exposure.

Michael Reis (Northwestern Mutual representing the ACLI) said that the ACLI is fine with the 15-day comment period. Mears directed IAO staff to update the amendment, taking into consideration the technical recommendations in the ACLI's comment letter, and re-expose for a 15-day comment period ending Jan. 9.

Mears said the point of this amendment was to ensure that the Structured Securities Group (SSG) team has the resources it needs to start working on this project.

Stolte made a motion, seconded by Cotrone, to authorize the SSG staff, pending finalization of this amendment, to take on this CLO analytic function and formally request the resources it may need. The motion passed unanimously.

3. Adopted an Amendment to the P&P Manual Updating Instructions for Related Party and SCA Investments

Mears said the next item on the agenda is to discuss comments and consider adoption of a proposed amendment to the P&P Manual to update instructions for related party and SCA investments.

Marc Perlman (NAIC) said this agenda item stems from a referral from the Statutory Accounting Principles (E) Working Group. On June 10, 2022, the Working Group sent a referral to the Task Force resulting from the Working Group's May 24, 2022, adoption of agenda item 2021-21: Related Party Report. The agenda item revised both *Statement of Statutory Accounting Principles (SSAP) No. 25—Affiliates and Other Related Parties* and *SSAP No. 43R—Loan-Backed and Structured Securities*, which raised comments about eligibility for filing exemption (FE) for various affiliated structures. The Working Group's amendment required new reporting information for investments that involve a related party as sponsor, originator, manager, or other similar transaction party, regardless of whether the investment is captured on the affiliate reporting line.

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

The Securities Valuation Office (SVO) proposes amending SCA section of the P&P Manual in the several ways. First, clarify that the section captures not only SCA investments, which are determined by control, but also *related party investments,* which include various other relationships between an insurer and transaction party. The related party example given during the Task Force's Oct. 20 meeting was an example the SVO saw of a familial, father-son relationship between the owner of the issuer and the chief executive officer (CEO) of the reporting insurance company. Second, amend the section so that investments with direct or indirect credit exposure to an SCA or related party of the insurer, whether as an issuer or otherwise, would be *ineligible* for FE. And third, investments

with an SCA or related party entity in the transaction structure but with *no* direct or indirect credit exposure to those entities (such as an issuing special-purpose entity [SPE], sponsor, originator, manager, etc.) would be FE unless otherwise ineligible for FE pursuant to P&P Manual guidance unrelated to SCA or related party status. However, the proposed amendment is clear that state insurance regulators can, in accordance with Part One of the P&P Manual, require an insurer to file an otherwise FE investment with the SVO for analysis and/or assignment of a designation, making that security ineligible for future FE.

A joint comment letter was received from the ACLI, the Private Placement Investors Association (PPiA), and the North American Securities Valuation Association (NASVA) that was generally supportive of the intent of the amendment but requested certain technical changes to better clarify that intent (Attachment 4-A). The SVO would recommend accepting those changes with the following edits:

In Part Three, paragraph 4, subclauses (1) and (2), the SVO recommends inserting the words "direct and indirect" prior to "credit risk exposure"; inserting "whether as issuer or otherwise" after "SCA or related party"; and moving the parenthetical "(each, as defined in this part)" to subclause (1) and in that subclause, spelling out in its entirety the terms "SCA and related party bond and preferred stock investments" so that the first sentence reads: "SCA and related party bond and preferred stock investments are comprised of two types of transactions: (1) SCA and related party bond and SCA and related party preferred stock investments (each, as defined in this Part) that have direct or indirect credit risk exposure to the SCA or related party, whether as issuer or otherwise, which are not filing exempt; and (2) SCA and related party investments that do not have any direct or indirect credit risk exposure to the SCA or related party, whether as issuer or otherwise, which are filing exempt."

In paragraph 247, the SVO recommends changing the term "credit exposure" to "credit risk exposure" to make it consistent with other references, adding the words "direct or indirect" prior to the references to "credit risk exposure" and, in subclause (ii), removing the word "underlying" with regard to the investment and changing the reference to "affiliates" to "SCAs."

There are two additional clean-up edits proposed: 1) in paragraph 248, inserting the word "stock" after "preferred"; and 2) as with paragraph 247, changing the references to "affiliated" to "SCA and related party."

Deborah Casey (Global Atlantic Financial Group representing the ACLI and NASVA) said the process was collaborative, making these changes along with other additional clarifications, and that they are satisfied with the results.

Stolte made a motion, seconded by Crawford, to adopt the amendment to update the instructions for related party and SCA investments with the technical revisions that Perlman presented (Attachment). The motion passed unanimously.

4. <u>Discussed Comments for a Proposed Amendment to the P&P Manual to Clarify the Definition of an NAIC Designation in Part One and Part Two</u>

Mears said the next item on the agenda is to discuss comments received on a proposed amendment to the P&P Manual to clarify the definition of an NAIC designation in Part One and Part Two. These clarifications are to recognize that NAIC designations are a specific risk measure created solely for NAIC regulatory purposes. The updates being proposed to Part One and Part Two are intended to further emphasize that NAIC designation are specifically intended to reflect their use in the NAIC's Financial Regulation Standards that have been incorporated into state law by the states as participants in the Accreditation Program. The amendment also intends to make the definitions consistent between these two parts of the P&P Manual.

Comment letters were received with some good suggestions and observations from the Capital Adequacy (E) Task Force and its risk-based capital (RBC) working groups. The comments indicate that additional work is needed by the Task Force to clarify the meanings for regulatory purposes. This will be an evolving process, but the Task Force will keep working on it.

Charles Therriault (NAIC) said the general purpose of NAIC designations, administered through the SVO, is to ensure that investments in securities made by state-regulated insurance companies are assessed according to objective and reasonably consistent standards for credit quality to accurately reflect those companies' financial solvency as required by state statutes. While some NAIC designations are assigned through the filing process relying upon a credit rating provider (CRP) rating, mapping to a corresponding NAIC designation, the mere fact that a CRP rating could be converted to a NAIC designation does not mean that the two are interchangeable. The proposed added language triers to clarify three issues that the SVO encounters regularly:

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

The proposed updates are not new principles and are consistent with existing policy statements by the Task Force. For example, in Part One, paragraph 89, the definition of an NAIC designation category states that it: "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."

The subsequent paragraph 90 in Part One adds that: "An objective of the VOST/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain."

In Part Two, paragraph 160, the definition of credit ratings eligible for translation to NAIC designations requires the rating to "apply to securities where the issuer promises to repay principal and interest or dividends" and "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."

To be clear, the Valuation of Securities (E) Task Force is in no way responsible for the assignment of RBC factors to any band of investment risk. However, NAIC designations are often used as an indication of risk in several NAIC processes, and it would be inappropriate for the Task Force to ignore how its work is used in other NAIC regulatory processes.

Three comment letters were received. The first was from Anderson Insights, which indicated support for the concept of clarifying the definition of NAIC designations and eliminating unnecessary language in the P&P Manual. The SVO agrees with that general objective and has made several efforts to improve the clarity of the P&P Manual over the past several years, including a full rewrite in 2018, and it is willing to continue to do so.

The second was a joint comment letter from the ACLI, the PPiA, and the NASVA. The letter also indicates that there could be additional improvements to clarify the purpose of NAIC designations and the connection between Part One, policies of the Task Force, and Part Two, the operational and administrative instruction to the SVO.

The third letter was from the Capital Adequacy (E) Task Force and its RBC working groups. As noted in their letter, these groups are responsible for the assignment of RBC factors to any band of investment risk. That is not the job of this Task Force.

The SVO did not want to propose substantial changes with this amendment. However, if the Task Force wishes, a more holistic review of the guidance in the P&P Manual can be conducted, and a revised amendment addressing these issues can be brought back to the Task Force. It will likely be a more substantial amendment.

Mears said it is important that the Task Force move forward with clarification of these definitions as it provides a foundation for what future actions would be. There is not a particular action or result that would come from the NAIC designation definitions themselves, but it helps to underlie future discussions or proposals that the Task Force may have. As an example, within the Statutory Accounting Principles (E) Working Group, there was a discussion about the interest maintenance reserve (IMR), and one of the key concepts behind that is the role of conservatism in statutory accounting. That is the concept that underlies the guidance. It does not result in an automatic answer with what to do with the IMR, and there will be a fulsome discussion of how to approach that going through the NAIC's normal due process, but it uses that concept of conservatism underlying it. That is a model of what the Task Force would look at as it creates these clarifications for what an NAIC designation means and provides an underlying framework on how to make future proposals or future assessments in assessing investment risk with the directions of the Task Force to the SVO. There are several changes needed to make that process clearer.

Reis said it is hard to argue that an NAIC designation should be consistent with the investment RBC factors. The ACLI wanted to raise questions of what the practical implications of that mean, and similarly with the changing of the notching language. The ACLI supports what was proposed.

Christopher Andersen (Andersen Insights) said he supports the idea of clarifying the definition and simplifying it. The comment letter submitted has specific proposals. There are three spots in the P&P Manual that define designations that can be consolidated. Part of clarifying the meaning of designations is to understand what designations are and are not. The regulatory interest and investor interest are in payment and payment as promised. If something does not pay as promised, and a bond is a promise to pay, that is default— something that is measured by credit ratings. A typical bond structure of a 10-year bond with a 5% coupon is a bond, and in 10 years, it will pay interest semiannually. A zero-coupon bond is a bond that may be a little riskier because the investor does not get the principal and interest until the end of the term. But they are both bonds. An analyst would look at those and look at the ability of the borrower in terms of their assets and cash flow, and their ability to meet the terms and conditions of the bond. What is seen in the P&P Manual is a reference to other risks of nonpayment. Some securities are assigned a subscript to indicate that there is other risk of nonpayment. Andersen said that his understanding is that risk of nonpayment is credit. The reason the investor is not paid is because the investor is unwilling or unable to pay, and that is default. That is a fundamental element to NAIC designations.

The P&P Manual does refer to other risks of nonpayment, so what could those be? If a bond performs and if the promise is fulfilled and the investor gets paid as promised, how can there be other disruptions? There are three examples. One is a callable bond. The same 10-year bond with a 5% coupon has a call in five years. The investor looks at that and can either book the five-year coupon or the 10-year coupon. The convention in the marketplace for a callable bond is that it is priced at the yield to worst. That means, from the investor's point of view, assume that the worst thing will happen. And depending on the call premium, in most instances, the worst thing that can happen is the bond will be called. If an insurer is expecting, hoping, or anticipating a 5% coupon for the back end of that transaction, they may get it for the final five years, but they may not. A conservative way of looking at that is to assume that it will not.

Another example is paid-in-kind (PIK). If the issue has the ability to pay the investor interest, or pay in more bonds/PIK, then the investor can assume that it will be paid, say, a 6% rate of interest for the entire term, or the investor can assume that it will essentially become a zero-coupon bond. That is the investor's choice. The conservative approach is to assume that the investor will be PIK, just as the conservative approach to looking at a callable bond is to assume that it will be called, and the investor will be disadvantaged.

A third example is a 1% 10-year bond, and all it pays is 1%, except if Tampa Bay wins the Super Bowl, then it is a 10% bond. The analyst must look at that and assess if this issuer can support a 10% coupon. Does it have the resources? That will affect the credit rating, probably adversely because of the hefty coupon, but the promise is the promise. In that instance, the issuer needs to assume that it might have to pay 10%, but the insurer should assume it pays no more than 1%. How is this operationalized? This is a basic concept that separates the notion of an NAIC designation and calls it basically credit ability and willingness of the borrower to pay. But the fine print is to pay what is promised. There is no promise to pay more than five years for the callable bond. There is no promise that a bond will not PIK. There is no promise that one will get a windfall. The rating tells the probability of that happening.

There are several ways that this can be operationalized. One way is to assume the worst. Another is that these are embedded options, either long or short, and they are optional provisions that the issuer controls. It is theoretically possible to value those options, but that would be difficult and would involve a lot of coordination. The question is how anything like this is advanced, and a discussion is needed with the Capital Adequacy (E) Task Force because, as has been mentioned, the RBC factor drives RBC in several respects. However, the idea of using the worst possibility, where there is an option on the behalf of the issuer, using the worst possibility, one could maybe justify notching, but that is far-fetched. If one reported the worst, things would be transparent. Instead of taking a callable bond and making an adjustment, if it is reported on the books and records as if it were called, then one has a more transparent situation than if one tried to adjust another metric. Andersen said that he does not see anything immediate that can happen and hopes this is brought into the discussion. He said as the Task Force looks at how an NAIC designation is supposed to be defined, he hopes that some of those considerations can be incorporated.

Mears said the last comment letter was from the Capital Adequacy (E) Task Force and its RBC working groups that are asking for the Valuation of Securities (E) Task Force to ensure that there is clarification that clearly it is not the role of this Task Force to establish RBC, but rather to provide valuable NAIC designations into that process. Botsko said that as the second letter indicates, the Capital Adequacy (E) Task Force and the RBC groups appreciate the follow-up discussion. With a better understanding of the intent that wished to be conveyed through that the additional language, these groups look forward to working with the Task Force on language that will suit everyone's needs.

Mears deferred action on this P&P Manual amendment to clarify the definition of an NAIC designation in Part One and Part Two at this time. She directed NAIC staff to continue to review the recommendations made in the letters and to work with the Capital Adequacy (E) Task Force to improve the verbiage and potentially make some other changes. The updated amendment will be brought back to the Task Force for further consideration.

5. <u>Exposed a Proposed P&P Manual Amendment to Add Instructions for Structured Equity and Funds</u>

Mears said the next item on the agenda is to discuss and consider exposure of a proposed P&P Manual amendment to add instructions for structured equity and funds. The SVO has processed several private letter rating (PLR) filings for investments in notes issued by a special purpose vehicle (SPV), trust, limited liability company, limited partnership, or other legal entity that operates as a feeder fund, which itself invests, directly or indirectly, in one or more funds or other equity investments. The SVO is concerned about this general structure that it is calling structured equity and funds because it can circumvent regulatory guidance from this Task Force,

the Statutory Accounting Principles (E) Working Group, and the Capital Adequacy (E) Task Force. It is enabled by the NAIC's reliance on rating agency ratings and permits potential RBC arbitrage given the role of the equity piece being treated as bonds. It ultimately lacks regulatory transparency because of the multiple layers of private entities and private ratings.

Mears said within the memorandum that was written, it notes that the Statutory Accounting Principles (E) Working Group has a bond project in place that will address how these are treated as bonds. That is a future state, presuming that moves forward as written, and it will not be implemented for a couple of years. There will be a wider universe of applicability in this amendment until that time where that bond universe would effectively shrink due to the Statutory Accounting Principles (E) Working Group bond projects coming into place. There is an interim impact to this and then maybe more of a long-term impact. The Task Force recognizes that many of these structures are clearly valid, but this amendment is looking for more transparency in order to differentiate between them.

Therriault said equity and fund investments that are structured through another legal entity have been able to qualify as bonds under the current regulatory definitions due to their legal form instead of substance as with the proposed bond definition before the Statutory Accounting Principles (E) Working Group. The investments are able to bypass the reporting requirements for equity and fund investments. These structures have sometimes been referred to generically as "rated notes," but they may be called other names. The general framework typically is based on an equity or fund investment, but they could just as easily be based upon any asset, including those of affiliates or non-admitted assets. These assets are being "transformed" into what the insurer reports as a bond through the insertion of an intervening legal entity, which issues a note that, due to a CRP rating, receives the statutory treatment of a bond for accounting, reporting, RBC, and NAIC designation purposes. This process exploits the inherent weakness within the FE process whereby anything with a CRP rating is assumed to be a "bond" and automatically treated as such despite its underlying assets, structure, or risk. These transactions can also permit the deferral of interest and/or principal payments, sometimes without capitalization and without being an event of default, introducing additional other nonpayment risks not reflected in the CRP ratings used in the FE process.

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

In the two examples included in the memorandum accompanying the amendment, the SVO walked through the structures, how the substance of the investment would have been treated if the insurer invested in it directly, how the actual investments issued would be treated, and the potential relative RBC impact of using the CRP rating for a structured equity and fund. In each example, assets that would not ordinarily be permitted to be reported as a bond were eventually filed as a "bond" after passing through an intervening legal entity to change the legal form but not the substance of the risk. They both received highly favorable private ratings from two different rating agencies. In the first example, an insurer relying on the CRP rating translation into an NAIC designation would be able to potentially reduce the implied RBC factor for the investment from 9.5% to 4.1%, a reduction of 56.6%. In the second example, an insurer relying on the CRP rating translation into an NAIC designation would be able to potentially reduce its implied RBC factor for the investment from 30% to 3.35%, a reduction of 88.8%.

As mentioned earlier, the Valuation of Securities (E) Task Force is not responsible for the assignment of RBC factors to any band of investment risk; that is the sole responsibility of the Capital Adequacy (E) Task Force and its RBC

groups. However, it is the reasonability of this Task Force to ensure that the assignment of an NAIC designation to any investment appropriately reflects a reasonable assessment of its credit risk. As these examples demonstrate, that is not currently occurring with structured equity and fund investments.

The FE process facilitates obscuring these investments with nondescript issue descriptions such as "senior notes" or "term loans." The multiple layers of private entities involved, coupled with private ratings, removes any transparency. A state insurance regulator would have no way to know by looking at the information available on Schedule D that these are complex structures investing in assets that could include affiliate investments, non-fixed income investments, derivatives, borrowings for the purpose of leverage, and non-admitted assets.

Given the magnitude of the potentially multiple regulatory arbitrage opportunities, the judgment involved in assessing the nature of the ultimate risk, the lack of transparency, circumvention of regulatory guidance, and the reliance on CRP ratings to accomplish these ends, the SVO proposes amending the P&P Manual to add a definition for structured equity and fund and to exclude such investments from FE eligibility. The proposed amendment would not change how the investment is classified for reporting by the insurer, but it would ensure that the NAIC designation and category assigned to it reasonably reflect the credit risk for NAIC purposes.

Mears said as the Task Force reads through the amendment during the exposure period, know that the potential procedure recognizes that there are quite a few underlying asset types that could be in these funds, and there may not be methodologies within the SVO to review them. The use of a CRP rating and getting the rating report may be used in many of these cases for review. That is in the proposed amendment, recognizing that that there could be a wide variety of assets and that the process would help create more of a validation around that CRP rating, with the ability to understand what those underlying assets are, effectively remove some of the lack of transparency that exists today, and look at what the underlying risk is of those assets.

Mears directed NAIC staff to expose the proposed amendment to add instructions for structured equity and fund investments for a 60-day public comment period ending Feb. 13, 2023. She directed NAIC staff to provide an informational referral to the Capital Adequacy (E) Task Force, given some of the components that are impactful to RBC.

6. Exposed a Proposed P&P Manual Amendment to Update References to 5GI

Mears said the next item on the agenda is to discuss and consider for exposure a non-substantive proposed P&P Manual amendment to update references to 5GI.

Perlman said that at the 2021 Fall National Meeting, the Task Force adopted a non-substantive technical amendment to the private letter rating securities section in Part Three of the P&P Manual, which clarified that an NAIC 5GI designation is the equivalent of an NAIC 5.B designation category. The SVO has identified other places in the P&P Manual where the 5.B GI designation category is not currently specified and proposed a non-substantive technical amendment to make those clarifying changes.

Mears directed NAIC staff to expose the proposed amendment to update references to 5GI for a 60-day public comment period ending Feb. 13, 2023.

7. Exposed an SSG Memorandum on a Proposed CLO Modeling Methodology (Excluding Scenarios and Probabilities)

Mears said the next item is to receive and consider exposure of an SSG memorandum on the proposed CLO modeling methodology.

Kolchinsky (NAIC) said that phase one of the process was to receive authorization, which was handled in the earlier agenda item two. This will permit starting the internal process to get the project going. Next is to discuss phase two of the project, which is the methodology, and then there will be phase three, which is the scenarios and probabilities modeling assumptions. The point of phase two is to set up the mechanics of the modeling. Hopefully, there are not too many controversial things in phase two, but the idea here is to set up modeling assumptions that are to be used so once this project gets to phase three, anyone can repeat the kind of work that is being done and get the same numbers so that everyone is speaking and working on the same page in terms of the scenarios and probabilities. If these modeling assumptions are set up, then the SSG can focus on the scenarios and probabilities, which will probably be a harder issue and more controversial as the other easier items will already be taken care of.

Included in the memorandum is an annex with all the assumptions. The SSG is asking interested parties and anyone else who wishes to comment three questions. First, are there any other assumptions, with the goal for complete transparency into the process, assuming that the default vector is known so there is a recovery assumption. What other information needs to be set up to make the modeling possible? Not everything may have been captured, and feedback is appreciated. Next, regarding the assumptions that have been listed, are they reasonable? Take out the default assumptions and recovery assumptions that will be talked about in phase three. Other than that, are these reasonable? There will also be an opportunity to comment on those together. And lastly, are there any other issues on any assumptions that would need to be taken care of?

If there are alternative assumptions presented or if there are any questions or unreasonableness of the assumptions that have been put into the annex, the SSG is asking for three things. The first is an actionable alternative, meaning something that that can be replicated not just by the interested party, but also by the whole market. If it is based on a proprietary model, which the participant does not intend to share, that is not something that is actionable. That is something that that can be replicated and by anyone in the market. Second, the SSG would like to see a quantitative justification for that assumption and a broadly historical justification as well, broader than the market expansion from 2011 to 2019. And lastly, the SSG would also like to ask that if there are any references to the suggestion in rating agency methodologies, if those could be referenced as well.

Chou asked about the modeling methodology. He asked that because a CLO is a complicated investment, is the SSG planning to work with other groups. He said that both the Life Actuarial (A) Task Force and the Risk-Based Capital Investment Risk and Evaluation (E) Working Group are working on this. The methodology, including the probability and scenarios, essentially is a stochastic model, mentioned in phase two and phase three. He said that in the past, there was bounce back and counter-discussion in the later stage that may cause more confusion if they are not included earlier.

Kolchinsky said the assumptions in phase two are just generic assumptions, which are normally used for modeling CLOs. The SSG is happy to work with Risk-Based Capital Investment Risk and Evaluation (E) Working Group and has had in-depth discussions with the American Academy of Actuaries (Academy) already and built a good relationship with them. The SSG is also happy to work with any other groups, such as the ones that have been mentioned at this stage. The scenarios will likely be more controversial. There have been good interactions with the Risk-Based Capital Investment Risk and Evaluation (E) Working Group, and several presentations have already been made to the Working Group. The SSG will keep it updated as work on this proposal continues. These are generic cash-flow assumptions that are not to converse in terms of how the market runs models for CLOs. Kolchinsky said that phase three is where the rubber meets the road.

Mears said Kolchinsky is involved with the Risk-Based Capital Investment Risk and Evaluation (E) Working Group with these presentations. The Academy had presented some of its initial comments on the potential for new C1 factors this morning. It is interconnected with this project. The modeling on its own is distinct, just like the setting

of the C1 factors is distinct, but they obviously have an interconnectivity that needs to be worked through as to what the implications are to both sides, so they do not operate in silos by any means.

Mears directed NAIC staff to expose the proposed CLO modeling methodology for a 60-day public comment period ending on Feb. 13, 2023.

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

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

Julie Gann (NAIC) said that as part of the coordination efforts to identify key things investment-related that may be of interest to this Task Force and interested parties, the Working Group had several items that were adopted or exposed yesterday during its meeting. She said the first adoption was simple; the Working Group adopted revisions to clarify that foreign open-ended investment funds is a type of fund in which the ownership interest is not deemed to reflect control unless the reporting entity actually has the power to direct the underlying company. That is consistent with guidance that already exists for exchange-traded funds (ETFs) and mutual funds, but it just did not have foreign open-ended investment funds included in the mix.

The Working Group adopted revisions to the derivatives standard. That has been done twice this year and then previously back in 2018 to become more converged with U.S. generally accepted accounting principles (GAAP) with regard to the assessment of derivative effectiveness. Those revisions are effective Jan. 1, 2023, and early adoption is permitted. This is being highlighted to this Task Force because the SVO bond-identified ETFs have a factor or component with regard to derivatives. Not being well versed in that guidance, the reason to highlight the derivative guidance change is to make sure that the Task Force is aware of it in case it must be considered with regard to that current guidance.

Gann said there are seven quick items to highlight for exposure. She said that all the comment deadlines for these exposures is Feb. 10, 2023 (three days prior to the Valuation of Securities (E) Task Force comment deadline) and again intended to give a little bit more time for the year-end reporting that occurs March 1. First, there is an exposure to expand the statutory accounting guidance for tax equity investments. That is a broad term that is being used right now. There is guidance in *SSAP No. 93—Low-Income Housing Tax Credit Property Investments* for low-income housing tax credits. There are other types of tax credit investments out there, but right now there is limited guidance for those specific name situations. This is a broad proposal to expand that guidance to encompass all tax equity investments that qualify in certain criteria. A discussion paper was exposed, and there is also an agenda item that really focuses on new market tax credits. Everyone is encouraged to review the discussion paper, which goes beyond new market tax credits. The Working Group would like to get information from industry as well as state insurance regulators, particularly on state-specific situations that exist.

There is the item that was mentioned earlier called the IMR. An agenda item was exposed regarding that topic. For those who may not be aware, IMR focuses on interest-related gains and losses because of sales of bonds. It is a hot topic right now. As a result of the Working Group's conversation with the exposure, a request was made to industry to provide some potential guardrails and details on unique considerations, and the Working Group directed NAIC staff to coordinate regular discussion with the Life Actuarial (A) Task Force. If there are states that are considering permitted practices with regard to this topic, there will also be a state or regulator-only memorandum for things to consider as part of that process.

Next, with regard to collateral loans, the Working Group exposed guidance, which is a re-exposure, to clarify that the underlying collateral must qualify as an admitted asset for the collateral loan to be admitted. This is an agenda item that is trying to be converged with the guidance on SSAP No. 20—Nonadmitted Assets, which has a small

section on collateral loans, and *SSAP No. 21R—Other Admitted Assets*, which also has a section on collateral loans. The discussion really focused on *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* type investments because those are required to be audited for admittance under statutory accounting. The question is whether they need to be audited in order for the underlying collateral for a collateral loan to be admitted.

Also, with regard to SSAP No. 25, guidance was exposed to clarify that any invested asset held by a reporting entity that is issued by an affiliated entity, or that includes the obligation of an affiliate entity, is an affiliated investment, and that is a follow-up for the related party guidance that was adopted earlier this year.

There is a new exposure for investment income due and accrued. This item predominantly data captures the current disclosure for interest income in *SSAP No. 34—Investment Income Due and Accrued*, but it does expand it slightly to capture information on PIK interest that is included in the current principal balance. This will also have a corresponding blanks proposal so that data can be captured information for 2023.

The Working Group also had an exposure related to working capital finance notes, which is a topic that has been shared with the Task Force over time. This is a little bit different. The U.S. Financial Accounting Standards Board (FASB) issued guidance related to these supplier program financing arrangements, but it was focusing on the creditor, and it incorporated new disclosures for those creditors in the U.S. GAAP financial statements. If the entity is the "Walmart" of the program and using these finance arrangements, right now there is inconsistency on how that is reported, with some companies reporting it as trade payables and other companies reporting it as debt. These are not disclosures that would be relevant to the reporting entity in their involvement because they are the investor in these programs. However, it may be something that would be worthwhile for companies that are looking to be investors in those programs, but for statutory, this was exposed to reject those disclosures.

The last exposure has to do with the bond proposal project. The Working Group exposed reporting revisions to detail going back to the Schedule-D general instructions and then the Schedule D-1-1 and the Schedule D-1-2, which is a new schedule. Interested parties' comments were considered and reflected and in the updated documents exposed for comments. Also exposed was a new issue paper, as well as reporting changes. NAIC staff have gone through all the blanks annual statement instructions and identified all instances in which bonds or loan-backed structured securities or anything that could be affected by these and identified recommendations for the revisions. It is extensive, for the most part. Because there are changes to reporting lines, there are a few schedules that will be significantly revised, such as the summary investment schedule, summary by country, and the Schedule D, Part 1A, which was exposed for comment. Earlier in November, the Working Group exposed updated statutory accounting revisions for the bond project, *SSAP No. 26R—Bonds* and *SSAP No. 43R—Loan-Backed and Structured Securities*. It is a document similar to the reporting one just mentioned where it goes through all the SSAPs and identifies other revisions that need to be reflected for the bond project.

9. <u>Discussed Other Matters</u>

Kolchinsky provided an update on the regular RMBS/CMBS year-end deliveries that should happen sometime between Dec. 16 and Dec. 20, with Dec. 19 being the most likely day for phase one delivery.

Mears said the Task Force has other initiatives that are still underway, even though maybe they have not been talked about in some time. There is always a lot of interest in the review of CRPs. There had been a small group that worked through some of these issues during 2022. That group will no longer meet because the Task Force is ready to move forward more in a regulator-only format and create a list of questions to start preliminary conversations with those CRPs. She said to anticipates seeing that kind of detail on upcoming agendas in 2023 as the Task Force moves forward with that process. Some of the other areas where the Task Force is looking at changes may be on hold as it figures out the NAIC designation definition and then circles back to see how those

changes fit in from an overarching perspective. She told the Task Force that if there is anything else that has been on their radar that has not been addressed recently, feel free to reach out, and updates can be provided.

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