
The following Valuation of Securities (E) Task Force members participated: James J. Donelon, Chair, represented by Stewart Guerin (LA); Todd E. Kiser, Vice Chair, represented by Jacob Garn (UT); Dave Jones represented by Tomoko Stock and John Finston (CA); Anne Melissa Dowling represented by Kathy Belfi and Elaine Wieche (CT); Chester A. McPherson represented by Philip Barlow (DC); Karen Weldin Stewart represented by David Lonchar (DE); Kevin M. McCarty represented by Robin Brown and Taris Smalls (FL); Nick Gerhart represented by Jim Armstrong (IA); Tom Lurkins (IL); Ken Selzer represented by Tian Xiao and Mark Birdsell (KS); Al Redmer Jr. represented by Matthew Kozak (MD); Bruce R. Range represented by Bruce Bornman (NE); Kenneth E. Kobylowski represented by John Sirovetz (NJ); Benjamin M. Lawsky represented by Jim Everett, Martha Lees and Mark McLeod (NY); John D. Doak represented by Joel Sander and Eli Snowbarger (OK); Teresa D. Miller represented by Kimberly Rankin and Steve Johnson (PA); David Mattax represented by Jamie Walker (TX); Jacqueline K. Cunningham represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays and Patrick McNaughton (WA); and Ted Nickel represented by Randy Milquet (WI). Also participating was Robert Wake (ME).

1. Voted to Refer the SVO Research Report on the NAIC Bank List to the Reinsurance (E) Task Force

During prior discussions of foreign bank eligibility criteria for the NAIC Bank List, the question arose about whether it should be expanded to include qualified U.S. financial institutions as defined under the Credit for Reinsurance Model Act (#785). Some members of the Reinsurance (E) Task Force wanted to ensure that non-bank entities would receive an equivalent level of regulation as banks. The Task Force asked the SVO to research the matter and report back.

Robert Carcano (NAIC) said that the SVO conducted legal research for three purposes: 1) to understand and describe the U.S. banking regulatory framework; 2) to evaluate which financial institutions may issue letters of credit (LOCs); and 3) to identify the source of legal authority to issue LOCs for different types of financial institutions. The research was then used to evaluate the impact that the expansion of the list would have on the regulation of this aspect of reinsurance arrangements. Mr. Carcano explained that technically a “bank” refers to commercial banks and to an entity that both accepts deposits and makes loans. Any entity that does not engage in both activities is a “non-bank,” a “financial institution,” or is referred to by its primary business (i.e., a mortgage lender). U.S. banking regulation is a system of dual regulation; federal and state governments have overlapping roles. In addition, at the federal level, different regulators are responsible for different aspects of an entity’s regulation. State banks are supervised jointly by state banking regulators and the FDIC or the Federal Reserve System (Federal Reserve). National banks are regulated primarily by the Office of the Comptroller of the Currency (OCC), the FDIC and also by the Federal Reserve because national banks also invest in the district federal reserve bank. Non-banks are regulated by one or more of the OCC, the FDIC or the Federal Reserve. The Federal Reserve regulates bank holding companies, financial-holding companies, some of their subsidiaries, and savings and loan holding companies (SLHCs). The Federal Reserve also regulates state banks that are members of that system, as well as U.S. branches of foreign banks and foreign branches of U.S. banks. The OCC regulates operating subsidiaries and financial holding companies’ subsidiaries of national banks. The FDIC is involved with any financial institution that accepts deposits.

Except for securities holdings companies, all banks and non-banks in the study have the authority to issue LOCs. The source of the authority changes according to the nature of the entity. Banks can issue LOCs because it is a general lending activity and part of the business of banking. Non-banks can issue LOCs in several ways: 1) the parent can issue an LOC (for example, a national bank that controls a financial subsidiary can conduct through a subsidiary any activity that the national bank may conduct directly); 2) a financial institution is accorded the same legal status as an entity that issues LOCs (for example, a foreign bank authorized by the OCC to have branches inside the U.S. has the same rights and privileges as a national bank); 3) the activity is closely related to banking (for example, a financial holding company may issue an LOC as an activity incidental to financial activity); 4) the activity is financial in nature (for example, a financial holding company may engage in any financial activity, be it complementary or incidental in nature to financial activity); and 5) the activity is closely related to non-banking (for example, bank holding companies and their bank and non-bank subsidiaries can issue LOCs involving an extension of credit). In conclusion, the research indicates that the U.S. system of dual regulation supports the attainment of...
Mr. Carcano began the presentation with Attachments Two and Three of the memorandum, and then moved back to the details of the proposed compilation framework. Attachment Three is an unmarked version of the proposed amendment and on page three, item (l) Reference to SVO List of Securities, is a proposed definitional bridge that would unite the compilation frame that is proposed in the amendment for the P&P Manual with the definition in Model #785 and the Credit for Reinsurance Model Regulation (#786). He went on to describe Step One of the proposed definitional bridge. The essence of paragraph (l) is that both Task Forces agree that “securities listed by the SVO” in Model #785 corresponds to the definition of “SVO list of securities” in paragraph (k) of the proposed text regarding the Compilation and Publication of the SVO List of Securities of Attachment Three. Paragraph (k)(1) makes mention of securities that are compiled in the Valuation of Securities (VOS) Process; the Filing Exempt (FE) Data File, which is the corresponding source for FE securities; the Residential Mortgage-Backed Securities(RMBS)/Commercial Mortgage-Backed Securities (CMBS) Modeled Securities, regulatory objectives expressed in the definition of qualified U.S. financial institutions in the Model #785 which requires that a qualified US financial institution be regulated by a state or federal bank regulator. Further, non-banks have had authority to issue LOCs for some time and, therefore, have had time to develop the experience necessary to conduct LOC operations.

In closing, Mr. Carcano said that if both Task Forces concluded that the NAIC should expand the bank list, SVO would recommended that it be allowed to determine standards and processes to ensure that the expanded list is managed according to the objectives of both the Model Law definition and to the financial criteria in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual).

The discussion turned to credit unions because some of them are very large financial institutions. Mr. Davis asked if there were any big enough and active enough that they might issue a Credit for Reinsurance LOC. Mr. Carcano said that issue had not been looked at, but that is one of the reasons SVO staff request that the SVO be permitted to develop criteria to manage the List in accordance with Model law objectives. Mr. Carcano also said that there is some protection against any financial institution providing LOC for reinsurance transactions because the P&P Manual stipulates that the entity must have a rating of AA or better. Mr. Davis said that credit unions both lend and accept deposits, and he asked if they were considered non-banks because funds are considered cooperative shares. Mr. Carcano said that credit unions appear to be banks. Mr. Davis then said that if the National Credit Union Administration (NCUA) is not a bank regulator, then credit unions do not fall under the definition of financial institutions within the meaning of Model #785. Mr. Carcano That the research sought to identify what types of institutions can issue LOCs and whether they were regulated by state and or federal bank regulators. It therefore did not focus on which institutions would want to provide letters of credit for reinsurance purposes. Mr Carcano noted that the institution would exercise its authority in the context of the oversight provided by the regulator and although the memorandum does not address the issue of behind-the-scenes oversight, it is important to understand that such processes exist and influence how institutions make decisions whether or not they should participate in a business activity.

Mr. Garn made a motion, seconded by Mr. Milquet, to receive and refer the report to the Reinsurance (E) Task Force with the understanding that the latter will advise the Valuation of Securities (E) Task Force if they want the bank list expanded to include qualified U.S. financial institutions. The motion passed.

2. Voted to Expose a Report on the SVO Compilation Function and the Meaning of “SVO-Listed Securities” in Model #785

The Valuation of Securities (E) Task Force and Reinsurance (E) Task Force have been working jointly to provide meaning for the above phrase. SVO staff have discovered that Model #785 references the SVO’s “compilation function.” On Oct. 29, 2014, the SVO was asked: 1) how this compilation process is conducted; 2) to evaluate the risk that securities that do not comply with NAIC regulatory objectives or standards could be added the compilation; and 3) to recommend appropriate amendments to the P&P Manual. Currently, the latter does not include a description of the compilation framework and, therefore, the SVO recommends an amendment to describe that function and define “SVO-Listed Securities” for reinsurance purposes.

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which is where the Structured Securities Group’s (SSG) work product is listed; and the U.S. Department of the Treasury (Treasury Department) and the Exempt U.S. Government Securities Processes. Under the proposal, these five sub-lists will be the core sources of information about securities the SVO compiles and publishes. Historically, this is what the SVO does for the Valuation of Security Task Force. It is securities-owned by insurance companies, which are required to report to their states with an NAIC designation; therefore, they are also filed with the SVO or, under an FE, an NAIC designation for them is produced using some other source. Step Two of the definitional bridge appears in paragraph (l). The purpose of this text is to provide a way for the Reinsurance (E) Task Force to identify and define populations of securities it deems eligible or ineligible for use as collateral in reinsurance arrangements whether or not they appear in the list of securities compiled by the SVO. If this mechanism were adopted, both Task Forces would coordinate any request to add a group of securities that would comply with the second part of the mechanism.

The definition of “SVO-listed securities” only references sub-lists of insurer-owned securities, but the compilation also contains information from other sub-lists. A separate definition of Other Securities was created that includes others lists that the SVO creates as part of the compilation. Together these steps build on each other’s sections to create a comprehensive framework. SVO staff recommend including a section of prohibited transaction such as regulatory securities.

Attachment Two is the source of all the lists and is divided into three sections. The first list is comprised of those in the VOS Process, the FE Data File and the SSG’s RMBS/CMBS Modeled Securities. All get designations or, in the case of the RMBS/CMBS, price grids from which designations are then derived. SVO staff propose that U.S. Treasuries and U.S. Exempt populations be made a sub-list. The second list is Valuations for Subsidiary, Controlled and Affiliated (SCA) investments, which are published exclusively for regulators on i-Site and are, therefore, excluded from the proposed definition of SVO Listed Securities. They are not designated but are regulated at a market or equity valuation basis. The third list contains all the other securities previously identified. SVO staff need guidance about where Surplus Notes should fall. Money market and Exchange Traded Funds are also excluded. The Task Forces also propose that investment security and regulatory security be defined. The main reason for the proposed prohibition of adding regulatory securities to any of these sub-lists is to address the concern expressed in October 2014 that a mechanism be created to block “bespoke securities,” alert insurance companies when a compliance issue crops up and allow the SVO to formally exclude them from the sub-lists.

The amendment also includes guidelines to ensure that when a state insurance department asks the NAIC to assess bespoke securities that this is done consistent with member expectations. Mr. Guerin summarized that the proposed definitional framework consists of two components: 1) a finite list of SVO-listed securities that are owned by insurance companies; and 2) issues that are not necessarily owned by insurance companies but that the Reinsurance (E) Task Force finds acceptable for collateral as well.

Ms. Lees said that defining securities listed by the SVO as outlined would greatly broaden the number of securities used as collateral. Mr. Guerin said that was yet to be determined. The Valuation of Securities (E) Task Force is turning to the Reinsurance (E) Task Force for guidance for what it wants to be included in that definition. Mr. Wake opined that the issue arose because nobody knows what the standard is, and there has not been any limitation other than regulatory discretion. The proposal would give back to the SVO some of the gatekeeper role that the Reinsurance (E) Task Force thought it was giving it in 1993, around the time the Valuation of Securities (E) Task Force procedures changed and the white list was eliminated. Todd Sells (NAIC) clarified that the confusion regarding “SVO-listed securities” cropped up because the SVO’s functions have morphed and progressed since the time that term was coined; therefore, the intent is not to recreate a past role, but rather to provide a consistent interpretation that would be adequate given its current activities. Mr. Wake brought up the SVO list of NAIC 6 securities, which should not be collateralizing reinsurance recoverables. Mr. Guerin reiterated that the Valuation of Securities (E) Task Force will follow what the Reinsurance (E) Task Force directs as to what it thinks is acceptable for reinsurance collateral purposes. Mr. Sells spoke of a separate part of the Credit for Reinsurance Model that deals with limitations on securities that are in trust and suggested that the initial definition of “SVO-listed securities” is for all types of collateral, and then there are further restrictions whenever it is in a trust. These distinctions might be useful for Reinsurance (E) Task Force to consider in guiding the Valuation of Securities (E) Task Force.

Steve Clayburn (American Council of Life Insurers—ACLI) asked for clarification regarding the exposure process. Mr. Guerin said that any comment letters are presented to the Valuation of Securities (E) Task Force for discussion. If this results in any amendments to the P&P Manual, then the Task Force must approve them. If there are no comments, the report is sent to the Reinsurance (E) Task Force.

Ms. Belfi made a motion, seconded by Ms. Stock, to receive and expose the report for a 30-day public comment period ending March 26 and to refer it back to Reinsurance (E) Task Force. The motion passed.
Having no further business the Reinsurance (E) Task Force adjourned.

3. **Discussed the Request for Assistance from the Life Risk-Based Capital (E) Working Group Pertaining to the Definition of “Other Securities”**

The Life Risk-Based Capital (E) Working Group has asked for the Task Force’s help to develop asset charges for “other securities” under the XXX/AXXX Reinsurance framework. The Working Group would like the SVO to describe the standards and criteria that would apply to an LOC, a guaranty or a transaction designated by the SVO under the existing Task Force standards.

Mr. Carcano discussed the SVO memorandum on this issue. The P&P Manual already includes the credit substitution methodology; hence, the memorandum only discusses the legal and credit standards that apply before a debtor’s obligation, which is supported by an LOC or a guaranty issued by a third party, can be designated. A credit substitution involves a creditor exchanging a lower credit exposure for a higher quality credit exposure. Credit substitution can only be obtained when the analysis indicates that the third party is, in fact, absolutely, unconditionally and irrevocably bound to pay the creditor for the debt of a specific obligor and obligation. LOCs and guaranties are frequently used in credit substitution to back bonds for this purpose. However, they are different instruments, create different legal relationships and thus present different legal and analytical issues. In terms of an issuer’s obligation to pay, a guaranty creates a secondary liability only, while an LOC creates a primary and independent obligation. A guarantee must be “of payment,” meaning the third party agrees to pay only if the obligor defaults. A guarantee of collection requires the creditor to exhaust efforts to collect from the obligor before having recourse to the third party. There are different instruments often referred to as guarantees that have different obligations such as sureties and comfort letters. The main issue with guarantees is that the law gives the third party defenses to payment known as “surety ship defenses.” In order to be the basis for credit substitution, the guarantor has to waive surety defenses and other defenses associated with the transaction. A guarantee that is suitable for credit substitution would be a guarantee of payment, rank pari passu with the third party’s senior unsecured obligation, be payable on the due date, provide for reinstatement if payments made to the creditor were clawed back under bankruptcy, be unconditional and waive surety defenses.

The LOC is a different instrument and was created for international trade. From the beginning, the courts characterized the issuer’s obligation to pay as primary and independent. The LOC issuer must pay upon the document’s presentation; an issue arises if the parties have agreed to condition payment on something other than presentation of documents. An LOC core standard is that it contain documentary conditions to payment only. Whether either a guaranty or an LOC is used, the analysis focuses upon the transaction discussed in the document and the support instrument. The manner in which the payment obligation is structured is also an important consideration to assigning a designation. Whether a credit substitution attempt is successful is determined by a combination of operational, mechanical, financial and legal analysis, all of which is described in detail in the memorandum. The memorandum also outlines how an LOC or a guaranty could be used as credit support in a bond issuance. The challenge faced by the Life Risk-Based Capital (E) Working Group is how to tailor this process to the reinsurance context. In order to achieve that, SVO staff would have to see how those transactions are structured. It is important that the SVO understand if there are any concerns or issues of reinsurance that would not occur in the bond context so that staff can consider how to address them.

Mr. Birdsall and Ed Toy (NAIC) clarified the charge from the Principle-Based Reserving Implementation (EX) Task Force that asks that the Life Risk-Based Capital (E) Working Group determine with respect to captive reinsurance transactions what RBC risk factors should be assigned to other assets such as those the Valuation of Securities (E) Task Force has been discussing. Another question is whether they are sufficiently “bond like” to base the RBC factor on the corporate bond factors that we currently have. Mr. Toy said that this relates to assets that are above and beyond what are admitted assets under statutory accounting principles. To the extent that there are admitted assets under statutory accounting principles, then whatever guidance is necessary would follow from there. There are other things that support the reserve requirements in a captive reinsurer. These instruments are not securities, and they are not assets, although they are often referred as such; they are instruments of various sorts. What we have heard often are LOCs, total return swaps and guarantees. The request from the Life Risk-Based Capital (E) Working Group is for the Valuation of Securities (E) Task Force to develop a set of criteria that it feels comfortable with whatever the instrument was that it was close enough to be treated “bond like” for only the purposes of captive reinsurance. Mr. Toy believes that a lot of the research that Mr. Carcano presented could already be folded into the discussion because much of the work addresses a lot of the concerns of credit substitution; however, unlike the examples described above, these are not LOCs or guaranties backing up a bond, but rather stand-alone instruments. To the extent that
the Task Force could develop criteria along these lines, it would form the core and the starting point for a process that includes RBC factors for bonds.

One key consideration is whether the SVO can feel comfortable assigning these instruments NAIC designations. Mr. Carcano said that guaranties can be structured so they can be designated like bonds. He emphasized that in order to properly develop criteria, the SVO would need to have a better understanding of how the reinsurance obligation itself is structured, as well as other pertinent details regarding these transactions. Only then can the SVO proceed to a formulation of proposed standards.

Mr. Toy and Mr. Birdsall outlined the tight time frame for the project. The Life Risk-Based Capital (E) Working Group needs the guidance to be in place by year-end 2015; changes have to be approved by the Capital Adequacy (E) Task Force by April 30. RBC instructions have to be formally adopted by June 30. Mr. Birdsall thanked Mr. Carcano for the speed and the thoroughness with which he worked. He further promised to provide the examples and information Mr. Carcano requested.

Mr. Everett asked about the procedure that will be used, given the complexity of some of these transactions. Mr. Toy answered that due to the tight deadlines, the simplest approach is the best. Mr. Carcano added that to be more technical, the LOC framework itself would be consulted. In the bond context, parties can choose any legal framework they want. Some parts of the Uniform Commercial Code (UCC) cannot be varied by agreement, but the general rule is parties can deviate from the standard by agreement as they wish. If a transaction were to be presented with a standard other than a UCC, staff would open the books to determine if the LOC in question is an independent and primary obligation of the issuer under that framework, as well as other pertinent payment details. Mr. Everett said that UCC-98 and UCP-100 are cited in the Model #785. Mr. Carcano said that considering other frameworks is a regulatory call.

Mr. Xiao made a motion, seconded by Mr. Milquet, to refer the report to the Life Risk-Based Capital (E) Working Group, and to have the Working Group and the SVO staff work together on the project in order to meet the Working Group’s deadline. The motion passed.

4. Received Comments on the SVO Report on the Impact of Changes in Rules Governing Money Market Funds

The report was exposed for a 60-day public comment period ending Jan. 18. No comments were received. The Task Force would like the SVO to continue to monitor the issue and report back at the Fall National Meeting.

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

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The Valuation of Securities (E) Task Force met in Washington, DC, Nov. 17, 2014. The following Task Force members participated: James J. Donelon, Chair, represented by Stewart Guerin (LA); Benjamin M. Lawsky, Vice Chair, represented by Maria Filipakis (NY); Dave Jones represented by Tomoko Stock and Kim Hudson (CA); Thomas B. Leonardi represented by Kathy Belfi and Elaine Wieche (CT); Chester A. MePherson represented by Philip Barlow (DC); Karen Weldon Stewart represented by David Lonchar (DE); Kevin M. McCarty represented by David Altmaier (FL); Nick Gerhart represented by Jim Armstrong (IA); Andrew Boron represented by Eric Moser (IL); Sandy Praeger represented by Tian Xiao (KS); Therese M. Goldsmith represented by Christopher Buchanan (MD); Bruce R. Ramge represented by Justin Schrader (NE); Kenneth E. Kobylowski represented by and Steve Kerner (NJ); Scott J. Kipper represented by Omar Akel (NV); John D. Doak represented by Eli Snowbarger and Joel Sander (OK); Michael F. Consedine represented by Kimberly Rankin (PA); Julia Rathgeber represented by Jamie Walker (TX); Todd E. Kiser represented by Jake Garn (UT); Jacqueline K. Cunningham represented by Doug Stolte (VA); Mike Kreidler represented by Patrick McNaughton (WA); and Ted Nickel represented by Randy Milquet (WI).

1. ** Adopted its Oct. 2, Sept. 17 and Sept. 11 Minutes**

Ms. Wieche made a motion, seconded by Ms. Stock, to adopt the Task Force’s Oct. 2 (Attachment One), Sept. 17 (Attachment Two) and Sept. 11 (Attachment Three) minutes. The motion carried.

2. ** Adopted the Securitization Data Quality (E) Working Group’s Sept. 29, Sept. 17 and Sept. 11 Minutes; Adopted its Report; Adopted its Amendment to the P & P Manual; and Voted to Disband the Working Group**

Mr. Garn gave the Working Group’s report to the Task Force. At the Summer National Meeting, the Task Force asked the Working Group to draft an amendment to the *Purposes and Procedures Manual of the NAIC Investment Valuation Office (P & P Manual)* on documentation standards for Re-REMIC residential mortgage-backed securities (RMBS) and commercial mortgage-back securities (CMBS). On Sept. 29, the Working Group adopted the new definition. This concludes the Working Group’s mission.

Mr. Garn made a motion, seconded by Ms. Wieche, to adopt the Securitization Data Quality (E) Working Group’s Sept. 29 (Attachment Four) and Sept. 11 minutes (Attachment Five), adopt its report, adopt the amendment and disband the Working Group. The motion carried.

3. **Received a Status Report on Projects Referred to the Statutory Accounting Principles (E) Working Group and the Reinsurance (E) Task Force**

Julie Gann (NAIC) was not present to provide an update for the Statutory Accounting Principles (E) Working Group, but Mr. Guerin provided the Task Force with a summary. Earlier in the Fall National Meeting, the Working Group discussed finalizing the priority listing for the Investment Reclassification Project. The Working Group plans to kick off the project in early January 2015 with two issues concerning the *Statement of Statutory Accounting Principles (SSAP) 26—Bonds, Excluding Loan-Backed and Structured Securities* definition of security and funds. This will involve joint calls with the Task Force and other groups that are likely to be affected. Mr. Guerin explained that the Reinsurance (E) Task Force referral will be received during the discussion of item 7 below.

4. **Voted to Refer Technical Guidance to the Financial Regulation Standards and Accreditation (F) Committee in Order to Assist States in Aligning State Law References to NAIC Designations and Related Processes**

The Recalibration Project is on hold until the Investment Risk-Based Capital (E) Working Group presents its findings. This referral is not picking up the Recalibration Project by the Task Force but is only referenced because that project was the origin for this analysis. In preparation for the project, the NAIC’s SVO reviewed all 50 states’ investment laws in order to determine how NAIC designations are described and handled therein. Given that some states’ investment laws contain inaccurate or outdated terminology regarding NAIC Designations, the proposed referral is to disseminate the results of the SVO review to all 50 states in order to achieve an improved and more uniform statutory framework and references to investment classification. Robert Carcano (NAIC) explained the specific recommendations being made (Attachment Six).
intended to address issues such as: erroneous references to NAIC designations as “class 1” and “class 2”; incorrect references to “credit ratings of the SVO”; etc.

Ms. Wieche made a motion to defer the referral related to the Financial Regulation Standards and Accreditation (F) Committee in Attachment Six in order to investigate if that committee can require states to modify their investment laws. Mr. Guerin clarified that the proposal does not require the states to modify their law; it is not an accreditation standard, and it is not a requirement of any kind. The referral entails the transmission of technical guidance through Financial Regulation Standards and Accreditation (F) Committee to the states that may or may not spur them to take action. Mr. Carcano mentioned that the Task Force charged the SVO to prepare the referral in question. The SVO initially thought that they could work with the Attorneys’ Roundtable, but this group is an ad-hoc group and not a regulator group. The staff then reached out to NAIC legal staff and worked with Julie L. Garber (NAIC), who advised that this type of guidance would be appropriate to send to the Committee. The referral is not intended as a mandatory process as the Committee has procedures to put items like this in front of states in a non-binding way. Mr. Barlow said that the attachment contained scenarios that the Committee might find confusing and wondered what other mechanism could be used to notify states about outdated or incorrect language in their investment laws. Mr. Guerin said that the Task Force is open to any suggestions as long as the states receive the information.

Ms. Wieche made a motion, seconded by Ms. Filipakis, to pend the proposed referral of Attachment Six the Financial Regulation Standards and Accreditation (F) Committee for further study as to whether that Committee can require states to modify their investment laws. Seven states voted yes, nine states voted no, and two states abstained. The motion failed.

Mr. Stolte made a motion, seconded by Mr. Armstrong, to approve the referral to the Financial Regulation Standards and Accreditation (F) Committee for non-binding, non-required action. The motion carried.

5. Heard a Report from the ACLI and the SVO Regarding Changes to the UK Accounting Standards and Voted to Charge the SVO to Study the Changes

Mike Monahan (American Council of Life Insurers - ACLI) explained that the UK modified its accounting standards recently. Given that the UK is listed in the P & P Manual as one of the countries whose generally accepted accounting principles (GAAP) does not have to be reconciled to U.S. GAAP, the changes will likely entail an amendment to the manual. Thus, the ACLI requested that the SVO study the issue and make appropriate recommendations to the Task Force at the Spring National Meeting.

Mr. Altmaier made a motion, seconded by Mr. Akel, to ask the SVO to conduct the study and report back. The motion carried.

6. Adopted an Amendment to the P & P Manual to Include Canadian Accounting Standards for Private Enterprises (ASPE) and French GAAP

On Oct. 2, the Task Force voted to expose a proposed amendment modifying Canadian GAAP to include its new accounting standards for private enterprises (ASPE) and to add French GAAP subject to additional documentation requirements for a 30-day comment period, ending Oct. 31. No comments were received.

Ms. Stock made a motion, seconded by Mr. Milquet, to adopt the amendment. The motion carried.

7. Adopted an Amendment to the P & P Manual to Make a Single Credit Rating Standard for Foreign and Domestic Banks on the NAIC Bank List and Directed the SVO to Study How Non-Banking Financial Institutions are Regulated

On May 9, an issue was raised by the Task Force regarding the reason for the disparity in credit rating eligibility standards for foreign and domestic banks in the NAIC Bank List (the List). The Task Force requested NAIC staff to review the matter, and they found no reason for the difference. The Task Force thus made a referral to the Reinsurance (E) Task Force to ensure that this was correct and that there were no other issues NAIC staff might not be aware of. The Task Force also asked the Reinsurance (E) Task Force if the List should include qualified financial institutions and not just banks. In a joint call Oct. 29, the Reinsurance (E) Task Force responded that it had not uncovered any rationale for the different credit rating criteria either; however, on the second point, it did express concern that other qualified financial institutions might not be as strictly regulated as banks. The Reinsurance (E) Task Force further recommended that the SVO investigate the issue. Once NAIC staff present their results, the Reinsurance (E) Task Force can determine if it should broaden the scope of the List. The P & P
Manual amendment in question solely concerns equalizing the eligibility criteria for domestic and foreign banks to a “triple B” (Baa/BBB) credit rating for both.

Ms. Stock asked if the SVO would study the definition of qualified financial institution. Mr. Guerin clarified that NAIC staff would study how financial institutions other than banks are regulated to determine if their regulatory standards are substantially similar to those for banks. The SVO will then present its findings to both task forces. The study will encompass foreign and domestic financial institutions.

Mr. Stolte made a motion, seconded by Mr. Garn, to adopt the amendment to equalize the eligibility criteria for domestic and foreign banks to get on the List and to direct the SVO to conduct the study mentioned above. The motion passed.

8. **Adopted an Amendment to the P & P Manual to Provide Guidance on Credit Ratings Eligible for Filing Exemptions Rule and on Instructions for its Application**

The original amendment involved language that elicited three comment letters regarding three concerns. The three concerns centered on: 1) the use of the word “continuously monitored” as too vague; 2) language that limited identifiers to specific ones such as CUSIP, Private Placement Number (PPN) and CUSIP International Numbering System (CINS); and 3) the use of “wish” as not being accurate or appropriate. Staff collaborated with the letter writers to draft a revised amendment, which it presented on the Oct. 2 call; however, there was confusion on this call as to the revised language. The proposed amendment includes the following language revisions, respectively: 1) replacing the disputed text with “at least annually”; 2) replacing the specific identifiers with the more general phrase “are assigned to a specific issue that must be specifically identified”; and 3) amending the phrase “or that it does not wish for NRSRO Credit Ratings to be used” to now read “… or that NAIC determines is not appropriate for NRSRO Credit Ratings to be used …”. Mr. Monahan agreed with Mr. Guerin that these changes were non-substantive and would not require a re-exposure.

Ms. Wieche made a motion, seconded by Mr. Akel, to adopt the revised amendment. The motion passed.

9. **Received a Status Report on the SSG’s 2014 Year-End Financial Modeling of RMBS and CMBS**

Eric Kolchinsky (NAIC) presented. He said that the 2014 year-end financial modeling was going well, and the Structured Securities Group (SSG) has proceeded to the quality assurance review of the CMBS and will start on the RMBS. Mr. Kolchinsky anticipates that all deliveries will be made according to schedule. He also reminded the Task Force that the Connecticut Avenue Securities (CAS) and Structured Agency Credit (STACR) securities are treated as structured notes; therefore, although PIMCO will include those results as part of the annual project, the results will be populated in the Valuation of Securities Database (VOS database), not in AVS+.

10. **Received a Report on the Status of the Private Letter Rating Project**

Charles Therriault (NAIC) presented the results of an SVO study of filing exceptions. The analysis found 5,740 securities, representing approximately $100 billion of investments. These were discovered when the SVO looked at filing-exempt securities that did not match the SVO’s eight credit rating provider (CRP) feeds. First, NAIC staff validated that the securities had a current and recognizable identifier (i.e., CUSIP, CINS or PPN). Then, NAIC staff excluded the following from the list: 1) government entity securities such as Fannie Mae and Freddie Mac, as well as the U.S. Treasury, since they are known to be filing-exempt; and 2) structured securities handled by the SSG. After coming up with the list, NAIC staff analyzed how they were set up and grouped them into categories, namely: 1) certificates of deposits; 2) government security; 3) preferred shares; 4) pre-refunded securities; 5) term loans (likely bank loans); 6) lottery securities; 7) securities that may have U.S. government guarantees; and 8) private placement numbers. NAIC staff are continuing to work with the ACLI and industry to identify the root cause for these exceptions. Once this is determined, the SVO will present its findings to the Task Force.

Mr. Monahan said that the project to reduce exceptions on the jump-start report is a win for both examiners that have to go into the companies and the companies themselves.

11. **Received a Staff Report on Change in Rules Governing Certain (MMFs)**

The SVO maintains two lists of money market funds (MMFs) that the Task Force has determined are eligible for treatment as bonds instead of common stock. The first is the U.S. Direct Obligation Full Faith and Credit Exempt List, consisting of funds that invest 100% of their assets in securities that are either the direct obligation of the U.S. government or backed by the full faith of the U.S. The second is the Class 1 List, consisting of: 1) funds that invest at least 97% of their total assets in any
combination of U.S. government securities; 2) securities that are rated in the highest credit rating by a CRP (i.e., corporate private transactions); or 3) securities that are unrated but the fund’s board of directors deems them to be of the same quality. The remaining 3% are required to be invested in second-tier securities. In July, the U.S. Securities and Exchange Commission (SEC) adopted changes to the rules governing MMFs, one of which specifically is of direct interest to the Task Force: the ability of MMFs to use valuation methods that result in stable net asset value (NAV). All MMFs can use stable NAV valuation methods, meaning that they can report a value of $1 per share of the MMF. The SEC ruled that it would no longer permit a specific type of fund to use stable NAV, and thus the fund would have to report value on the basis of floating NAV—in other words, whatever the funds are worth on the market at any particular point in time. The fund that was targeted is referred to as an Institutional Prime MMF. It requires a very high dollar value investment that would be out of the reach of individuals or retail, hence “institutional.” “Prime” refers to MMFs that hold private corporate securities.

The first NAIC MMF list falls under the SEC definition of a government MMF and is safe. However, the current Class 1 List does not conform to the new definition and, therefore, those MMFs would need to be modified in order to comply with the SEC. The SEC allows a two-year transition period so that MMFs can decide whether to reorganize, go out of business or create a new fund. NAIC staff believe the issue will resolve itself as the fund managers decide how to comply. The expectation is that most of the MMFs will be eliminated from the list in the upcoming two years. The SVO will continue to monitor this issue and report back with anything of note. Mr. Guerin added that funds of this nature fall under the purview of the Statutory Accounting Principles (E) Working Group’s Investment Reclassification Project; hence, the accounting for these MMFs could change as well.

Ms. Filipakis requested that the Working Group be made aware of the potential redemption issue. Mr. Guerin reassured her that this would be done.

Mr. Milquet made a motion, seconded by Mr. Altmaier, to receive and expose the report on the new rules governing MMFs (Attachment Nine) for a 60-day comment period, ending Jan. 18, 2015. The motion carried.

12. **Voted to Expose Report on the Referral from the Financial Condition (E) Committee to Evaluate Model #282**

The Task Force has received a referral (Attachment Seven) from the Financial Condition (E) Committee requesting that it review the Derivatives Instruments Model Regulation (#282). The Committee requested that the Task Force weigh in on whether it should be retained or amended as a model law, converted to guidance, or archived. The review is a routine process of an NAIC process called the Model Law Review Initiative required by the NAIC Procedures for Model Law Development. The procedures contemplate that the rates of adoption of model laws by the states would be indicative of member support for the model. However, NAIC staff do not believe that a low level of adoption relieves the reviewer from going further. In 2005, the Task Force received a similar request to review Model #282. At that time, NAIC staff found that 19 states had adopted the NAIC’s Investments of Insurers Model Law (#280), which contains derivatives text that mirror Model #282. In addition, four other states had adopted Model #280. After the Task Force revised Model #280 in 2007, one additional state adopted it. Hence, it seems like 23 states have some form of legislation that mirrors the NAIC standard on derivatives. In 2005, the Task Force created a study group to review changes in the derivatives marketplace and its regulation; that study led to a revision of NAIC standards in Blanks, reporting and accounting concepts. Lastly, the study served as a guide for the Task Force to make recommendations on Model Regulation 282 and retention of the Model #280.

Mr. Armstrong made a motion, seconded by Mr. Stolte, to receive and expose the report for a 90-day comment period ending Feb. 17, 2015. The motion carried.

13. **Voted to Expose a Presentation from Nationwide Proposing a Review of the Regulatory Framework for Cat Bonds**

Nationwide presented a proposal (Attachment Eight) requesting that the Task Force support a review of the RBC and statutory accounting treatment for catastrophe-linked bonds (cat bonds) held by life insurance companies.

John P. Lebens, Steven Chenenko and Rajiv Thomas (Nationwide) presented a white paper that was put together with the support of the North American Chief Risk Officers Council. The premise of the white paper is that there is a wide source of untapped diversification within the insurance industry, specifically between catastrophe risk, which mainly resides on P/C balance sheets, and credit risk, which is a large component of life insurers investments. The potential diversification can be untapped via cat bonds, which could be purchased by life insurance companies. Currently these companies do not play a significant role in the cat bond market, likely due to the capital treatment cat bonds receive on a life insurance company’s balance sheet where they are treated as corporate bonds even though the default risk of cat bonds has little relationship to corporate bonds. Bonds held by life insurance companies fall under the RBC C1 factor under which unrated bonds are treated.
as Class 6 bonds. About one-third is not rated. Therefore, Nationwide believes that the diversification should be reflected differently. P/C insurers would benefit from the deeper source of capital, while life insurance companies would benefit from a more diversified portfolio and better return on RBC. From a regulatory standpoint, more diversification is better and also benefits the consumer.

Mr. Armstrong asked why some cat bonds are not rated. Mr. Thomas answered that in the past, a lot more bonds were rated, but during the last 12 months to 18 months, the trend has been not to rate them due to a significant increase in demand. Issuers have tried to cut the cost for ratings and while life insurance companies would require a rating, they are not major participants. As more life insurers enter the market, more cat bonds will be rated. Mr. Armstrong asked why they are all rated below investment grade. Mr. Thomas said that when Standard & Poor’s (S&P) rates cat bonds, it imposes ratings ceilings. Also, S&P rates by looking at the cat bond’s risk modeling only. However, when an investor looks at the cat bond, there is a certain amount of diversification. Mr. Armstrong asked if S&P takes into consideration cat bonds diversification when it rates a life insurance company and evaluates its capital. Mr. Chenenko said that S&P rates it similarly to any other corporate bond. Mr. Armstrong said that he worried about allowing the proposal. Ms. Filipakis suggested that the proposal be presented to the Capital Adequacy (E) Task Force. Mr. Guerin agreed. The discussion then turned to the NAIC designation for unrated cat bonds, which are treated as 6*. It was suggested that perhaps the Task Force, in a joint effort with the Capital Adequacy (E) Task Force, should try to determine if 6* should still be applied to non-rated cat bonds or if they would require a different treatment.

Ms. Wieche made a motion, seconded by Mr. Kerner, to expose the presentation and the proposal for a 60-day comment period ending Jan. 18, 2015. The motion carried.

Having no further business, the Valuation of Securities (E) Task Force adjourned.
Proposal to Modify Capital Treatment for Catastrophe Bonds Held by Life Insurance Companies

I. Executive Summary

Capital management for insurance companies hinges upon the ability to effectively diversify risks. Catastrophe bonds offer a largely untapped source of risk diversification between property and casualty (P&C) insurers and life insurers. Today, however, these benefits are limited by capital and accounting constructs which fail to recognize this inherent source of diversification and result in barriers for life insurers to invest in these instruments.

Modifications to the existing capital and accounting of catastrophe bonds would yield benefits across the continuum of insurance constituents, including the following:

- P&C insurers would benefit from a larger and more stable source of capital, thereby reducing their cost of capital.
- Life insurers would benefit from improved risk-adjusted asset returns as natural catastrophe risk and systemic investment risk are largely uncorrelated and, as a result, can provide a diversification benefit.
- A lower cost of capital for P&C insurers could improve the availability and affordability of insurance products, thereby benefiting P&C customers.
- Life insurance customers would benefit from improved risk-adjusted returns.
- Regulators’ solvency concerns would diminish as greater diversification is introduced into the system.

II. Overview of P&C catastrophe bonds

Developed in the mid ’90s, catastrophe (Cat) bonds are risk-linked securities issued by insurance or reinsurance companies that are designed to protect an insurance company from large losses incurred in the event of a major catastrophe that causes losses far in excess of the insurance premiums received.

The return an investor receives from holding Cat bonds is a function of the expected loss (typically estimated using catastrophe models) for a pre-specified catastrophe loss within a particular time-period. The occurrence of the catastrophic event (typically a low probability scenario) triggers the loss of the investor’s principal, which passes to the insurance company and helps it pay claims arising in the aftermath of the disaster. On the other hand, if the catastrophic event fails to take place within the predetermined time-period (typically a high
probability scenario) the investor earns a return on its bond, which is based upon the expected loss to the bond (typically based on modeled results).

Cat bonds can be designed to cover any natural disaster. Some popular issuances cover US hurricanes and earthquakes, European windstorms along with Japanese earthquakes and typhoons. The bonds have floating interest rates and are usually paid off upon maturity in three or four years.

An insurance company issues bonds through an investment bank which takes on the role of an underwriter or placement agent. The bonds are then sold to investors through a special purpose reinsurance vehicle. Bond principal is put into a trust and typically used to purchase highly liquid assets such as short-term US Treasury securities, money market assets, or other similar short-term cash equivalent securities. As long as this remains the case the bond principal would not be subject to the credit risk of the insurer or reinsurance vehicle. Note that the coupon payments would still be subject to the credit risk of the insurer since it is funded by the premium payments the insurer makes to the special purpose reinsurance vehicle. The flow of funds in a typical transaction is shown in the illustration below.

**Figure 1: Illustration of a Cat Bond**

- Insurer pays premium to the special purpose reinsurer (Cat Re) who will indemnify it for certain types of loss up to a fixed limit.
- To fund this limit, Cat Re issues bonds to capital market investors (institutions).
- Bond principal goes into a trust and is invested in money market assets.
- Investors receive a fixed interest payment equal to the money market yield plus a spread that is equal to the premium the insurer pays to Cat Re.
If insurer experiences a triggering loss from a catastrophe above a specified threshold, investors will lose all or part of their principal and the insurance company would use this money to pay their claims.

If no catastrophe occurred during the term of the bond, the principal is returned to investors.

The Cat bond market currently has over $20 billion of capital outstanding – a mere fraction of the total debt outstanding on the worldwide bond market. Despite the limited market depth, there is a secondary market in Cat bonds that trades daily and provides a reasonable level of liquidity.

III. Current state of the Cat bond market

Insurers are issuing Cat bonds at the fastest rate since before the financial crisis. Yields on cat bonds have sunk to their lowest level in nine years due to the low interest rate environment. The average quarterly yield recently dipped to 5.22% recently, down from 9.61% in 2012. Investors have also been attracted by the idiosyncratic, and therefore diversifying, nature of returns. Over the last decade, Cat bonds as an asset class have outperformed comparable bond indices as well as the S&P 500 as shown in the graphic below. The returns on Cat bonds have also been much less volatile than other asset classes. It should be noted, however, that as a relatively new asset class, the performance observations on catastrophe bonds are based upon a comparatively limited time frame (vs. the broader stock or fixed income markets). Nonetheless, these assets do present a theoretically diversifying source of return for investors.
Cat bond issuance in the first quarter of 2014 more than doubled from the prior year period, to $1.2 billion, and second-quarter issuance is expected to hit an all-time high above $3.5 billion.
according to Willis Capital Markets & Advisory (Willis). Willis indicates that more than $2 billion of deals have closed or have been announced in the third-quarter.

Cat bonds historically have appealed to money managers and large pension funds but are now attracting a wider array of buyers, yield-hungry investors who otherwise might purchase high yield corporate bonds, according to brokers, bankers and investors. “Institutions of smaller and smaller size are becoming interested in the market,” said Brett Houghton, a managing principal at Connecticut-based Fermat Capital Management LLC, a long-standing specialist in Cat bonds, with $4.4 billion under management.

Cat bond issuance jumped to $7.1 billion last year, just shy of the record $7.2 billion in 2007. About $20.3 billion of the bonds were outstanding at the end of 2013, the most ever. About $300 billion of catastrophe-reinsurance coverage is in place world-wide, including Cat bonds.

The Swiss Re Global Cat Bond Total Return Index, which tracks the price change and interest payments of all property natural-catastrophe bonds outstanding, returned 8.51% on an annual basis between 2002 and 2013. By comparison, Barclays’s U.S. Corporate High Yield and U.S. Aggregate Bond indexes have increased, respectively, 9.35% and 5.04% annually. As both new forms of capital enter the market, and new sources and/or amounts of catastrophe risk are ceded via catastrophe bonds, these return dynamics will likely continue to evolve along with the market.

Natural disasters have caused losses to cat bonds of $682 million since 1996, or 1.3% of the $51 billion issued, according to Lane Financial LLC, an insurance consulting firm.

Yields on Cat bonds typically rise after natural disasters, reflecting lower bond prices and higher coupons on newer issues seeking to attract buyers. After Hurricane Katrina, which caused $47.4 billion in insured losses in 2012 dollars, yields rose 147% through the next four quarters, according to Lane Financial LLC.

### IV. Portfolio diversification benefits of Cat bonds

The returns from Cat bonds are largely uncorrelated with macroeconomic factors. This unique characteristic allows them to bring valuable diversification attributes to portfolios of more traditional asset classes and holds particular appeal in uncertain financial climates when investors may wish to protect themselves from market forces. For example, in the 2008 financial crisis, Cat bonds were one of the few asset classes that provided positive returns over the course of the year.
Cat bonds are not highly exposed to traditional sources of credit risk because:

- Principal is secured by a third-party trust agreement and invested in low-risk instruments like money market accounts; and
- Default is triggered by a natural catastrophe exceeding a preset threshold, making it similar to an insurance contract.

Historical monthly return data from 2001 to 2013 illustrates the low correlation of Cat bond returns with equities and corporate bonds:

- Analyzing periods of negative returns in these asset classes indicates that Cat bond returns are 15% correlated to both equity and corporate bond returns.
  - Over 156 months, negative returns occurred in 13 months for the Cat bond index and 48 months for the corporate bond index.
  - In only 5 of 156 months did both decline: 2 months in 2005 (Katrina), 2 months in 2008 (Ike) and 1 month in 2012 (winter storm events).
  - During Katrina in 2005 and winter storm events in 2012, financial market disruptions were minor showing little to no impact from the catastrophic events.
  - Ike occurred during the financial crisis in 2008. Market losses were severe but unrelated to Ike.
- There is no causal relationship from economic risk to catastrophe risk; a down economy will not cause a natural disaster or catastrophic event.

---

Figure 3: 2008 Total Return

<table>
<thead>
<tr>
<th>3-5 Year U.S. Treasury Notes</th>
<th>Aon Benfield All Bond ILS Index</th>
<th>ABS 3-5 Year, Fixed Rate</th>
<th>3-5 Year BB US High Yield Index</th>
<th>CMBS 3-5 Year, Fixed Rate</th>
<th>S&amp;P 500</th>
</tr>
</thead>
<tbody>
<tr>
<td>12.2%</td>
<td>4.0%</td>
<td>-18.2%</td>
<td>-17.5%</td>
<td>-10.9%</td>
<td>-38.5%</td>
</tr>
</tbody>
</table>

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Although natural disasters can impact geographic regions and industry sectors, they are unlikely to result in a systemic impact to the overall financial market and a well-diversified investment portfolio.

The table shown below illustrates the low correlation of Cat bonds (shown under ILS – Insurance Linked Securities) and selected asset classes using historical monthly return data from 2001 to 2013.

**Figure 4: Correlation of monthly returns since 31 Dec 2000**

<table>
<thead>
<tr>
<th></th>
<th>ILS</th>
<th>U.S. Corporate BB</th>
<th>U.S. Treasury Notes</th>
<th>S &amp; P 500</th>
<th>Hedge Fund</th>
<th>Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>ILS</td>
<td>1.00</td>
<td>0.19</td>
<td>0.04</td>
<td>0.25</td>
<td>0.27</td>
<td>0.16</td>
</tr>
<tr>
<td>U.S. Corporate BB</td>
<td>0.19</td>
<td>1.00</td>
<td>0.05</td>
<td>0.30</td>
<td>0.40</td>
<td>0.34</td>
</tr>
<tr>
<td>U.S. Treasury Notes</td>
<td>0.04</td>
<td>0.05</td>
<td>1.00</td>
<td>-0.39</td>
<td>-0.26</td>
<td>-0.16</td>
</tr>
<tr>
<td>S &amp; P 500</td>
<td>0.25</td>
<td>0.30</td>
<td>-0.39</td>
<td>1.00</td>
<td>0.60</td>
<td>0.66</td>
</tr>
<tr>
<td>Hedge Fund</td>
<td>0.27</td>
<td>0.40</td>
<td>-0.26</td>
<td>0.60</td>
<td>1.00</td>
<td>0.48</td>
</tr>
<tr>
<td>Property</td>
<td>0.16</td>
<td>0.34</td>
<td>-0.16</td>
<td>0.66</td>
<td>0.48</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Source: Aon Benfield Securities, Inc.

Another attractive feature of Cat bonds is that poor performance tends to be self-correcting. Following a particularly destructive natural disaster, a number of factors serve to increase insurance premiums (and thus the potential returns to catastrophe risk securities), providing investors with the opportunity to recoup some, if not all, of their losses within a relatively short time-frame. These factors include increased demand for insurance, a reduced ability of insurance and reinsurance companies to take on risk, and upward revision of the probability models that are used to price insurance and catastrophe risk securities. We saw this following the recent events of hurricane Katrina as shown in the graphic below. Also, while prices on existing bonds would decline as spreads widen out on new bonds, the relatively short duration of Cat bonds would serve to minimize such declines.

---

4 Source: Aon Benfield Securities, Inc.
Further, while investors face the possibility of losing some or all of their principal investment in the event that a catastrophe does occur, their risk exposure can be dramatically reduced by diversifying across many different Cat bonds as the probability of numerous large-scale natural disasters occurring within the same limited time frame is very low. For example in 2005, in spite of heavy losses associated with hurricane Katrina, many catastrophe risk funds still made money overall, as evidenced in the table below.

### Table 2: Historical Total Return of Cat Bonds

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Aon Benfield All Bond ILS Index</td>
<td>9.1%</td>
<td>8.4%</td>
<td>7.5%</td>
<td>6.1%</td>
<td>1.6%</td>
<td>10.0%</td>
<td>14.3%</td>
<td>4.0%</td>
<td>12.4%</td>
<td>11.3%</td>
<td>3.7%</td>
<td>9.7%</td>
<td>10.9%</td>
</tr>
</tbody>
</table>

### V. Barriers to life companies investing in Cat bonds

To date, life insurers have not been significant investors in the Cat bond market as shown in the table below.

---

5 Source: Aon Benfield Securities, Inc.
6 Source: Aon Benfield Securities, Inc.
Several barriers exist currently which limit life reinsurers exposure to P&C issued Cat bonds:

1. **Capital charge**: For life companies, Cat bond investments receive the same RBC treatment as similarly rated below investment grade corporate bonds. For unrated Cat bonds, a significant portion of issuance, investments receive equity RBC treatment. As a result, life companies do not receive any diversification credit for this uncorrelated asset risk (treated as low grade corporate credit or equity risk).

   For example, on a BB bond the capital charge is about 3.4% and categorized under C1 - Asset Risk component as shown in the figure below. The result is an overall capital charge of $16.9M for a $500M bond and does not provide any differentiation between a corporate bond and a Cat bond; it does not recognize the diversification benefits of a Cat bond.

---

7 Source: Aon Benfield Securities, Inc.
Table 3: RBC calculation under current method (C-1o component)

<table>
<thead>
<tr>
<th>Component</th>
<th>Description</th>
<th>Actual 2013</th>
<th>Pro Forma +17.0 in C-1o</th>
</tr>
</thead>
<tbody>
<tr>
<td>C-0</td>
<td>Affiliated</td>
<td>59.0</td>
<td>59.0</td>
</tr>
<tr>
<td>C-1cs</td>
<td>Asset Risk - Common Stock</td>
<td>2.8</td>
<td>2.8</td>
</tr>
<tr>
<td>C-1o</td>
<td>Asset Risk - All Other</td>
<td>156.2</td>
<td>173.2</td>
</tr>
<tr>
<td>C-2</td>
<td>Insurance Risk</td>
<td>23.7</td>
<td>23.7</td>
</tr>
<tr>
<td>C-3a</td>
<td>Interest Rate Risk</td>
<td>65.3</td>
<td>65.3</td>
</tr>
<tr>
<td>C-3b</td>
<td>Health Credit Risk</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>C-3c</td>
<td>Market Risk</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>C-4a</td>
<td>Business Risk</td>
<td>30.8</td>
<td>30.8</td>
</tr>
<tr>
<td>C-4b</td>
<td>Business Risk</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>C-2b</td>
<td>Catastrophe Risk</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

CAL\(^1\) = Total After Covariance
Difference over Actual

\(^1\) Company Action Level (CAL) = C-0 + C-4a + Sqrt [(C-1o + C-3a)^2 + (C-1cs + C-3c)^2 + (C-2)^2 + (C-3b)^2 + (C-4b)^2 + (C-2b)^2]

2. **Accounting treatment:** For unrated Cat bonds (categorized as NAIC 6), the bonds are marked to market under statutory accounting, driving capital volatility. They are also assessed a hefty capital charge of 19.5%, as shown in the table below. Over the past year there has been an increase in Cat bonds that are unrated, as issuing companies have seen a high demand for Cat bonds from investors and chose to avoid rating costs. If life insurance companies become larger investors in the Cat bond market, then more issuers would choose to get their bonds rated to attract more capacity.

Table 4: RBC Factors for Bonds by NAIC Rating

<table>
<thead>
<tr>
<th>Category</th>
<th>Pre-Tax Factor</th>
<th>After-Tax Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exempt</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>NAIC 1</td>
<td>0.4%</td>
<td>0.3%</td>
</tr>
<tr>
<td>NAIC 2</td>
<td>1.3%</td>
<td>1.0%</td>
</tr>
<tr>
<td>NAIC 3</td>
<td>4.6%</td>
<td>3.4%</td>
</tr>
<tr>
<td>NAIC 4</td>
<td>10.0%</td>
<td>7.4%</td>
</tr>
<tr>
<td>NAIC 5</td>
<td>23.0%</td>
<td>17.0%</td>
</tr>
<tr>
<td>NAIC 6</td>
<td>30.0%</td>
<td>19.5%</td>
</tr>
</tbody>
</table>
3. **Information asymmetry**: Life insurers typically lack expertise and/or transparency into the modeling/measurement of the risk. The risks in a Cat bond are significantly different from those of a corporate bond and it requires specialized knowledge to properly assess these risks. Typically an investment bank acts as an intermediary in the issuance of a Cat bond and can assist an investor in their risk assessment. This lack of life industry expertise would still likely pose near term challenges to broad life company investment in catastrophe bonds.

4. **Restrictions on amount of investments in below investment grade bonds**: A vast majority of the Cat bonds in the market are rated below BB by S&P, partly due to ratings caps and qualitative considerations used in the ratings process. The ratings do not consider diversification benefits of Cat bonds. The restrictions on below investment grade bonds are primarily self-imposed by companies and well within the regulatory maximums, so this is not a highly constraining factor.

### VI. Benefits for insurance industry

P&C Cat bonds can be a diversifying risk for life insurance companies. The underlying structure in a Cat bond is an insurance contract, not a financial asset. This diversification effect can result in improved risk adjusted returns on a life insurance company’s portfolio.

---

8. Source: Aon Benfield Securities, Inc.
Expansion of the investor base to include life insurance companies would put downward pressure on Cat bond and related reinsurance pricing. We estimate the entry of life insurance companies as investors in Cat bonds could at least double the Cat bond market capital capacity. This would lead to improving insurance availability in catastrophe prone areas. The increased investor demand could tighten spreads 50 to 150 bps depending on other market conditions. More importantly, it will also serve to stabilize the capacity in the overall reinsurance market, especially after major natural disasters, by providing a source of stable capital capacity to the P&C insurance industry.

**VII. Reducing the barriers for life companies via modified capital treatment**

To appropriately measure the risk and capital requirements of these instruments, and thereby encourage greater investment by life insurers into Cat bonds, the current capital charges would need to be modified.

An example of an alternative approach is described below. There are several viable alternative approaches that could be considered and (this example is meant to demonstrate one).

The alternative method attempts to recognize the insurance features of a Cat bond, as well as the diversification benefit to life insurance companies. It does not change the capital charge assigned to bonds by financial rating. Rather, it places the capital charge under the “C2-Insurance Risk component”. This recognizes that the underlying contract behind a Cat bonds is an insurance contract because its valuation is primarily determined by weather events unlike a typical corporate bond which is affected by financial credit risk and market risk.

Continuing on the example of a $500M bond from the previous section, the table below shows the impact of this alternative on RBC.

The first pro forma column shows the impact of a $500M bond with BB charges of 3.4% which is the current method.

The second pro forma column shows the impact from the alternative method of adding the 3.4% charge to C2 - Insurance Risk.
Table 5: RBC calculation under an illustrative alternative methodology (C-2 component)

<table>
<thead>
<tr>
<th>Component</th>
<th>Description</th>
<th>Actual</th>
<th>Current Pro Forma</th>
<th>Alternative Pro Forma</th>
</tr>
</thead>
<tbody>
<tr>
<td>C-0</td>
<td>Affiliated</td>
<td>59.0</td>
<td>59.0</td>
<td>59.0</td>
</tr>
<tr>
<td>C-1cs</td>
<td>Asset Risk - Common Stock</td>
<td>2.8</td>
<td>2.8</td>
<td>2.8</td>
</tr>
<tr>
<td>C-1o</td>
<td>Asset Risk - All Other</td>
<td>156.2</td>
<td>173.2</td>
<td>156.2</td>
</tr>
<tr>
<td>C-2</td>
<td>Insurance Risk</td>
<td>23.7</td>
<td>23.7</td>
<td>40.7</td>
</tr>
<tr>
<td>C-3a</td>
<td>Interest Rate Risk</td>
<td>65.3</td>
<td>65.3</td>
<td>65.3</td>
</tr>
<tr>
<td>C-3b</td>
<td>Health Credit Risk</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>C-3c</td>
<td>Market Risk</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>C-4a</td>
<td>Business Risk</td>
<td>30.8</td>
<td>30.8</td>
<td>30.8</td>
</tr>
<tr>
<td>C-4b</td>
<td>Business Risk</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>C-2b</td>
<td>Catastrophe Risk</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

CAL¹

| Difference over Actual | 16.9 | 2.4 |

¹ Company Action Level (CAL) = C-0 + C-4a + Sqrt [(C-1o + C-3a)^2 + (C-1cs + C-3c)^2 + (C-2)^2 + (C-3b)^2 + (C-4b)^2 + (C-2b)^2 ]

This illustrative alternative treatment would result in the overall capital charge reducing from $16.9M to $2.4M. The example shown above is representative of a large company with more than $1 billion in assets. It should be noted that some companies may have a different diversification profile than the example above. Industry data indicates that the average life insurance company as well as larger companies (more than $1 billion in assets) have a significantly lower proportion of capital charge coming from C-2 relative to the sum of C-1o and C-3a used in the RBC formula.. Smaller companies (less than $1 billion in assets) generally have a higher proportion of capital charge coming from C-2 relative to the sum of C-1o and C-3a and would not benefit from the illustrated alternative above. We presume that larger companies would be more likely candidates for purchasing Cat bonds and therefore this method would practically have a positive impact. Nonetheless, the intent of any solution should be to allow for catastrophe risk to be appropriately diversifying to a risk portfolio with low correlation. An alternative to this approach could be to create a separate risk charge for these instruments and their unique risk profile – separate from C-1o, C-3a, or C-2. A new “C-2a” risk component could uniquely capture the insurer’s exposure to Catastrophe Risk, thereby allowing a more tailored diversification calculation.

Another alternative would be to classify Cat bonds with a one or two-notch upgrade relative to the standard NAIC classifications. This upgrade would reflect the diversifying nature of Cat bonds.
bonds with the other assets but do so via an enhancement to the risk charge derived from the NAIC classification.

VIII. Conclusion

Cat bonds are a large source of risk diversification between P&C insurers and life insurers that needs to be expanded. Modifying the capital treatment of Cat bonds for life companies would encourage greater investment by life insurers into Cat bonds, which in turn would provide greater diversification of risks within the insurance industry. This would benefit all constituents of the insurance industry, including the following:

- P&C insurers would benefit from a larger and more stable source of capital, thereby reducing their cost of capital.
- Life insurers would benefit from improved risk-adjusted asset returns as natural catastrophe risk and systemic investment risk are largely uncorrelated and, as a result, can provide a diversification benefit.
- A lower cost of capital for P&C insurers could improve the availability and affordability of insurance products, thereby benefiting P&C customers.
- Life insurance customers would benefit from improved risk-adjusted returns.
- Regulators’ solvency concerns would diminish as greater diversification is introduced into the system.

References

1. Spotlight on catastrophe bonds, Schroders, Rosalind Mann and Katie Green, October 2013
This publication was sponsored by members of the North American CRO Council. The content of this article reflects the view of the majority of the Council and not necessarily the opinion of every member company.
NAIC Meeting

Discussion of Life Insurer Capital Treatment for Catastrophe Bonds

John Lebens, Steve Chenenko & Rajiv Thomas

November 17, 2014
Discussion Overview

<table>
<thead>
<tr>
<th>Risk Diversification</th>
</tr>
</thead>
<tbody>
<tr>
<td>• One of the fundamental tenets of insurance is the benefit of risk diversification</td>
</tr>
<tr>
<td>• Diversification benefits between two primary industry risks - catastrophe risk within P&amp;C insurers and credit risk in Life insurers - is largely ignored in today’s regulatory capital frameworks</td>
</tr>
<tr>
<td>• Accordingly, this potential benefit is generally not realized, which negatively impacts insurers, regulators, and ultimately consumers</td>
</tr>
<tr>
<td>• Catastrophe bonds offer life insurers a mechanism to diversify their portfolios to take advantage of the inherent diversification between catastrophe risk and credit risk; however given the lack of recognition of these benefits, Life insurers are not active investors in these instruments</td>
</tr>
<tr>
<td>• <em>A modification to the risk based capital treatment of catastrophe bonds would provide a more appropriate measure of the underlying risk and would reduce the barriers for life insurers to participate in this space, thereby enhancing industry risk diversification benefits</em></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Insurers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• P&amp;C insurers would benefit from a larger and more stable source of capital, thereby reducing their cost of capital</td>
</tr>
<tr>
<td>• Life insurers would benefit from improved risk-adjusted asset returns as natural catastrophe risk and systemic investment risk are largely uncorrelated and, as a result, can provide a diversification benefit</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Regulators</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Solvency concerns would be reduced as greater diversification is introduced into the system</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Consumers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ultimately the benefit inures to the end consumer</td>
</tr>
<tr>
<td>• Life insurance customers would benefit from improved risk-adjusted returns</td>
</tr>
<tr>
<td>• Property and casualty consumers would benefit from a more stable and less expensive source of capital for P&amp;C insurers which would result in improved availability and affordability of insurance products</td>
</tr>
</tbody>
</table>
Overview of Cat Bonds

• Catastrophe (Cat) bonds are risk-linked securities issued by insurance companies that are designed to protect an insurance company from large losses incurred in the event of a major catastrophe
• The flow of funds in a typical transaction is shown in the illustration above
  – Cat Re issues bonds to institutional investors
    › Investor proceeds are placed into a trust and typically invested in highly liquid short term cash equivalent securities
  – Insurer enters into a reinsurance contract with Cat Re
    › Insurer pays reinsurance premiums to Cat Re
    › In the event of a triggering loss from a catastrophe above a specified threshold, the insurance company receives funds from the trust equivalent to the reinsurance coverage purchased
  – Investors receive a fixed interest payment equal to the yield on trust assets plus a spread that is equal to the premium the insurer pays to Cat Re
    › If there is a catastrophe loss above a specified threshold, investors will lose all or part of their principal
    › If there is no catastrophe loss during the term of the bond, the principal is returned to investors
Cat Bonds Provide Portfolio Diversification

- Cat bonds are largely uncorrelated with macroeconomic factors, as evidenced by the positive returns during the 2008 financial crisis.

- Cat bonds are not highly exposed to traditional sources of credit risk:
  - Most cat bond structures issued today have the principal secured by a third-party trust agreement and invested in highly liquid cash equivalent securities like Treasuries and money market accounts.
  - In these types of structures, credit risk is limited to the issuer’s ability to make premium payments which ultimately flow to the investors via the coupon payment.
  - Principal default is triggered by a natural catastrophe exceeding a preset threshold, making it similar to an insurance contract.

- Historical return data indicates a low correlation of Cat bond returns with equities and corporate bonds.

- There is no causal relationship from economic risk to catastrophe risk (a down economy will not cause a natural disaster or catastrophic event).

- Although natural disasters can impact geographic regions and industry sectors, they are unlikely to result in a systemic impact to the overall financial market.

<table>
<thead>
<tr>
<th>2008 Total Return</th>
<th>3-5 Year U.S. Treasury Notes</th>
<th>Aon Benfield All Year, Fixed Rate</th>
<th>ABS 3-5 Year, Fixed Rate</th>
<th>3-5 Year US High Yield Index</th>
<th>CMBS 3-5 Year, Fixed Rate</th>
<th>S&amp;P 500</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>12.2%</td>
<td>-18.2%</td>
<td>-17.5%</td>
<td>-10.9%</td>
<td>-38.5%</td>
<td></td>
</tr>
<tr>
<td>ILS – Insurance Linked Securities (primarily Cat Bonds)</td>
<td>4.0%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-18.2%</td>
</tr>
</tbody>
</table>
Life Insurers Are Not Significant Investors

- Several barriers currently exist which limit Life insurer investment in Cat bonds
  - Capital Charge
    - Cat bond investments receive the same RBC treatment as similarly rated below investment grade corporate bonds
    - For unrated Cat bonds, a significant portion of issuance, investments receive equity RBC treatment with a hefty capital charge of 19.5%
    - Do not receive any diversification credit for this uncorrelated asset risk
  - Accounting Treatment - for unrated Cat bonds (categorized as NAIC 6), the bonds are marked to market under statutory accounting, driving capital volatility
  - Information Asymmetry - Life insurers typically lack expertise and/or transparency into the modeling of the risk

- We believe a revised capital treatment could reduce these barriers and increase the demand of Cat bonds by life insurers, leading to
  - A larger proportion of bonds being rated by issuers
  - More resources and talent dedicated to this area by life insurers

![Cat Bond Participation by Investor Type (2014)](image-url)
Current RBC Treatment for Cat Bonds

Acme Life Insurance Company
$ millions

<table>
<thead>
<tr>
<th>Component</th>
<th>Description</th>
<th>Capital Values Prior to Cat Bond Acquisition</th>
<th>Capital Values Post Cat Bond Acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>C-0</td>
<td>Affiliated</td>
<td>59.0</td>
<td>59.0</td>
</tr>
<tr>
<td>C-1cs</td>
<td>Asset Risk - Common Stock</td>
<td>2.8</td>
<td>2.8</td>
</tr>
<tr>
<td>C-1o</td>
<td>Asset Risk - All Other</td>
<td>156.2</td>
<td>173.2</td>
</tr>
<tr>
<td>C-2</td>
<td>Insurance Risk</td>
<td>23.7</td>
<td>23.7</td>
</tr>
<tr>
<td>C-3a</td>
<td>Interest Rate Risk</td>
<td>65.3</td>
<td>65.3</td>
</tr>
<tr>
<td>C-3b</td>
<td>Health Credit Risk</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>C-3c</td>
<td>Market Risk</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>C-4a</td>
<td>Business Risk</td>
<td>30.8</td>
<td>30.8</td>
</tr>
<tr>
<td>C-4b</td>
<td>Business Risk</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>RBC</td>
<td>Total After Covariance</td>
<td>312.7</td>
<td>329.6</td>
</tr>
</tbody>
</table>

Acme acquires $500m of BB rated Cat bonds
Capital charge for BB rated bonds = 3.4%
Asset Risk C-1o increases by $17.0m ($500m x 3.4%)

+$16.9m in RBC

- On a BB bond the capital charge is about 3.4% and categorized under C1 - Asset Risk component
- Results is an overall capital charge of $16.9m for a $500m bond
- Does not provide any differentiation between a corporate bond and a Cat bond and ignores the diversification benefits of a Cat bond.
Example of an Alternate RBC Treatment

Acme Life Insurance Company

$ millions

<table>
<thead>
<tr>
<th>Component</th>
<th>Description</th>
<th>Capital Values Prior to Cat Bond Acquisition</th>
<th>Capital Values Post Cat Bond Acquisition</th>
</tr>
</thead>
<tbody>
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</tr>
<tr>
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<td>156.2</td>
</tr>
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<td>23.7</td>
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</tr>
<tr>
<td>C-3a</td>
<td>Interest Rate Risk</td>
<td>65.3</td>
<td>65.3</td>
</tr>
<tr>
<td>C-3b</td>
<td>Health Credit Risk</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>C-3c</td>
<td>Market Risk</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>C-4a</td>
<td>Business Risk</td>
<td>30.8</td>
<td>30.8</td>
</tr>
<tr>
<td>C-4b</td>
<td>Business Risk</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>RBC</td>
<td>Total After Covariance</td>
<td>312.7</td>
<td>315.1</td>
</tr>
</tbody>
</table>

Acme acquires $500m of BB rated Cat bonds

Capital charge for BB rated bonds = 3.4%

Insurance Risk C-2 increases by $17.0m ($500m x 3.4%)

• Alternate method attempts to recognize the insurance features of a Cat bond, as well as the diversification benefit to life insurance companies

• Places the capital charge under the C2- Insurance Risk component - recognizes that the underlying contract behind a Cat bond is an insurance contract because its valuation is primarily determined by weather events unlike a typical corporate bond which is affected by financial credit risk and market risk

• This alternative treatment would result in the overall capital charge reducing from $16.9m to $2.4m for a $500m bond
Conclusion

- Risk diversification is a fundamental component of an efficient insurance system

- Today, there exists a largely untapped source of diversification between catastrophe risk, a large source of P&C risk, and credit, a large source of life insurer risk

- A modification to the risk based capital treatment of catastrophe bonds held by life insurance companies would provide a more appropriate measure of the underlying risk and would reduce the barriers for increased participation of life insurers in this space

- Increased life insurer demand for P&C catastrophe bonds would yield benefits across the continuum of insurance constituents including P&C and life insurers, regulators, and ultimately the consumers of insurance products
January 16, 2015

Hon. Stewart Guerin  
Chair, Valuation of Securities (E) Task Force  
Members of the Valuation of Securities (E) Task Force  
National Association of Insurance Commissioners  
1100 Walnut Street, Suite 1500  
Kansas City, MO 64106-2197

Attn: Charles Therriault, Director, NAIC Securities Valuation Office  
Robert Carcano, Senior Counsel, NAIC Investment Analysis Office  
Marly Kurtzer, Administrative Assistant, NAIC

Re: Proposal to Modify Capital Treatment for Catastrophe Bonds Held by Life Insurance Companies

Dear Chairman Guerin and Task Force Members:

The NAIC's Valuation of Securities (E) Task Force has received a proposal to change the capital treatment of catastrophe (cat) bonds held by admitted life insurers and has surfaced that proposal for comment. As CEO of the California Earthquake Authority (CEA), which operates one of the world's largest catastrophe-risk-transfer programs, I encourage the Task Force to undertake a comprehensive analysis of this proposal, with an eye toward eliminating unnecessary regulatory barriers to the continued development of a robust and competitive cat-bond market.

The CEA is a publicly managed, privately funded organization that provides earthquake insurance to California renters and residential-property owners. The CEA’s mission rests on three pillars:

- **Educate** – Help Californians learn about the significant perils posed by earthquakes.
- **Mitigate** – Help Californians strengthen their homes, to protect against earthquake damage and lower losses.
- **Insure** – Develop and provide residential earthquake-insurance products that are sold throughout California, backing that insured exposure with prudent and efficient cession of selected parts of that catastrophe risk through appropriate risk-transfer markets.

California Earthquake Authority | 801 K Street, Sacramento, CA 95814  
Phone: 916.661.5000 | Fax: 916.327.8270

© 2015 National Association of Insurers Commissioners
Throughout its 18-year history, CEA’s earthquake-insurance mission has placed it among the world’s largest consumers of catastrophe reinsurance and other forms of catastrophe risk-transfer. And over the past years the CEA has been a leader and innovator in the emergence of an increasingly dynamic, responsive, and well capitalized cat-bond market—that market emergence, with other factors, has helped significantly reduce the aggregate cost of CEA’s risk-transfer programs. The reduced expense has been extremely beneficial for CEA’s policyholders in the form of substantially lower premium rates and much-increased product flexibility. CEA wants that trend to continue.

Hon. Stewart Guerin  
Chair, Valuation of Securities (E) Task Force  
January 16, 2015  
Page 2

The cat-bond market now stands at record levels, with approximately $25 billion outstanding at year-end 2014 and $8.8 billion in 2014 issuances. Cat-bond investors are, by and large, highly specialized entities, and include insurance-linked securities (“ILS”) investors, reinsurers, multi-strategy hedge funds, pension funds, and large money managers.

This new record level of cat bonds outstanding is being driven by capital-market investors’ increasing attraction to the asset class. Investors such as pension funds continue to grow their allocations to catastrophe risk and reinsurance. Investors of all types are searching for yield and asset-class diversification, in part because of the protracted low-interest-rate environment. And all investors can benefit from the uncorrelated nature of catastrophe bonds to other asset classes and relatively higher interest rates versus other fixed-income investments.

CEA and its policyholders have been major beneficiaries of the emergence and growth of this robust risk-transfer market. In CEA’s view, these developments indicate a healthy and dynamic market—a market that can continue growing in good health within a system of prudent and principled regulatory policy. CEA respects the important role the Task Force and its parent committee play in evaluating any proposed modification to the regulatory systems and standards that could affect the growth of this market.

CEA is not a regulator, and we offer no opinion on the specific proposal that is currently surfaced for comment. But we encourage the Task Force to carefully review and consider the proposal, as well as any other proposals that might enhance the stable and prudent growth of this vital and increasingly important risk-transfer market.
If the Task Force, the NAIC, and its member states ultimately conclude that the cat-bond market can safely expand its investor base and increase demand for cat bonds by adjusting the risk-based-capital standards that apply to life-insurance-company investors, CEA would welcome the entrance of these sophisticated investors into the market.

Thank you for surfacing this proposal for comment. CEA looks forward to following this issue as the work of the Task Force continues.

Sincerely,

Glenn A. Pomeroy
Chief Executive Officer
MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force
    Members of the Valuation of Securities (E) Task Force

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office

CC: Charles Therriault, Director, NAIC Securities Valuation Office

DATE: January 12, 2015


1. Issue and Summary Discussion - Part Two, Sections 5 of the Purposes and Procedures Manual is a Special Reporting Instruction commonly called the 5*/6* Rule (pronounced five-star/six-star). Section 5 (f) and (g) of the Rule permit insurers to obtain a 5* or a 6* from the SVO upon a certification that the insurer lacks documentation necessary for the SVO to assign an NAIC Designation but is receiving agreed upon payments and expects to continue to do so. Section 5 (f) and (g) also provide that the SVO may assign NAIC 5* and NAIC 6* Designations to structured securities. The SVO has determined that the phrase refers to a group of complex corporate securities in Part Three Section 3 (a) and (b) of the Purposes and Procedures Manual. Part Three, Section 3 (a) and (b) of the Purposes and Procedures Manual refers to these securities as structured securities and to the SVO function assigned to evaluate them as the SVO structured securities group. In addition, the NAIC Proceedings indicate that a primary concern of Section 5 (f) and (g) was insurers that could not report securities to the SVO because they lacked the legal right to require the issuer to obtain an Audited Financial Statement. This confirms that the phrase refers to the complex corporate securities in Part Three, Section 3 (a) and (b) because credit assessment of such securities requires an Audited Financial Statement while the assessment of securitizations would not. The NAIC Proceedings also show that the Rule was intended to apply to securities required to be filed with the SVO. This would also confirm that Section 5 (f) and (g) does not apply to securitizations because the SVO was never assigned a securitization assessment mission. The SVO therefore recommends that Section 5 (f) and (g) be amended to refer to Part Three, Section 3 (a) and (b) of the Purposes and Procedures Manual.

2. Background

(i) The 120-Day Rule and Self-Designation under the Z Process – A security subject to filing with the SVO is required to be filed within 120 days after purchase (the 120-day rule). Because the SVO may not be able to provide an NAIC Designation to the insurer for a security purchased in the year-end time period, a rule was created to permit insurers to self-designate a security and report it to regulators (the Z Rule) with the administrative symbol Z, provided they comply with the 120-day rule. The expectation was that the SVO would assign a designation to the security in the addendum period or in the next reporting period.
(ii) Concern with Misuse of the Z Process – In 1995, after identifying several populations of perpetually self-designated bond populations, the SVO proposed that it be permitted to assign NAIC 5 Designations to such securities. The Invested Assets (E) Working Group found that insurers owned and were perpetually self-designating securities for which they lacked a legal right to require the issuer to obtain an audited financial statement or where the cost of translating financial information into English to permit an SVO assessment would be prohibitively high.

(iii) Regulator Intent - The record indicates that the Task Force adopted the Rule to require the filing of financial information for securities that were required to be filed with the SVO to provide the NAIC with analytical judgments about the quality of securities produced by the SVO. Section 5 (a) and (b) of the Rule provided an insurer that self-designated a security during the first reporting period after purchase must file the security with the SVO for a designation or a 5* or 6*. Specific solutions for certain populations of securities identified by the Working Group were developed and inserted in Section 5 (i) of the Rule. The Rule was effective with the 1999 year-end process.

(iv) Conclusions – The NAIC Proceedings show that the 5*/6* Rule was a response to known population of securities. Section 5 (i) and other sections of the Purposes and Procedures Manual shows the Task Force preferred to identify specific populations eligible for 5* or 6*. Section 5 (f) and (g) was created for a relatively small remaining population(s). This approach would be consistent with the determination to rely on analytically determined designations and with the fact that 5*/6* legitimizes securities as an admitted asset and should therefore be applied only when characteristics of securities are known.

The phrase structured securities in Part 5 (f) and (g) refers to a specific group of complex corporate securities and not to securitizations. The Purposes and Procedures Manual has for some time referred to a group of structurally complex corporate securities as structured securities or transactions and to the SVO staff segment responsible for assessment of this population of securities as the structured transaction group.

The only reference to securitizations in the Purposes and Procedures Manual occurs in relation to the financial modeling of RMBS and CMBS in Part Seven of the Purposes and Procedures Manual. Part Seven provides that an RMBS or CMBS that cannot be modeled (due to lack of information in deal libraries) and that is not rated by a credit rating provider (CRP) (so that the modified filing exemption rules does not apply) would be filed with the SSG for a 5* as part of financial modeling methodology per Section 5 (i) of the Rule.

Section 5 (f) and (g) cannot reasonably be read to apply to securitizations because the Rule applies only to securities that are required to be filed with the SVO. Securitizations were never required to be filed with the SVO, except during 2009 -2011 when the NAIC adopted financial modeling as discussed above. Financial modeling is now conducted by the SSG.

The NAIC Proceedings indicate that the population of securities that insurers were self-designating could not be filed with the SVO because the insurer could not require the issuer to obtain an Audited Financial Statement. Securitizations are not assessed using audited financial statements.

The SVO therefore recommends that Section 5 (f) and (g) be amended to refer to Part Three, Section 3 (a) and (b) of the Purposes and Procedures Manual.

3. Information about the 5*/6* Population

<table>
<thead>
<tr>
<th>Year-End</th>
<th>12/31/2013</th>
<th>12/31/2012</th>
<th>12/31/2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>5*/6* VOS Issues</td>
<td>391</td>
<td>426</td>
<td>431</td>
</tr>
<tr>
<td>Reported 5*/6*</td>
<td>345</td>
<td>375</td>
<td>359</td>
</tr>
<tr>
<td>Overall Exposure</td>
<td>$9.1 Billion</td>
<td>$8.7 Billion</td>
<td>$1.7 Billion</td>
</tr>
</tbody>
</table>
The table above shows an increase in the size of the population, based upon overall dollar exposure, of more than 435% within the last three years.

<table>
<thead>
<tr>
<th>2013</th>
<th>Quarter 1</th>
<th>Quarter 2</th>
<th>Quarter 3</th>
<th>Quarter 4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>VOS 5*/6* Issues</td>
<td>9</td>
<td>23</td>
<td>102</td>
<td>211</td>
<td>345</td>
</tr>
<tr>
<td>% Total</td>
<td>2.6%</td>
<td>6.7%</td>
<td>29.6%</td>
<td>61.1%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

In the above table, we isolate the 5*/6* population as of Dec. 31, 2013. The table shows 345 of the 391 unique CUSIPs were filed and reviewed after September; i.e., 77 in September, 69 in October, 21 in November and 121 in December, for a total of 83.4% (288/345).

<table>
<thead>
<tr>
<th>Category</th>
<th>Total Unique CUSIPs</th>
<th>BACV ($millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate</td>
<td>262</td>
<td>$8,938.9</td>
</tr>
<tr>
<td>Structured</td>
<td>57</td>
<td>$102.6</td>
</tr>
<tr>
<td>Municipal</td>
<td>26</td>
<td>$35.0</td>
</tr>
<tr>
<td>Total</td>
<td>345</td>
<td>$9,076.5</td>
</tr>
</tbody>
</table>

The table above breaks down the 345 securities assigned 5* or 6* in 2013 into the three major categories affected.

4. Conclusion - The SVO recommends that Section 5 (f) and (g) be amended to refer to Part Three, Section 3 (a) and (b) of the Purposes and Procedures Manual to identify the intended meaning of the phrase “structured securities” in the SVO context.

END NOTES

1 Part Two, Section 7

2 Part One, Section 3 (b)(v)

3 “… the Working Group reviewed and then requested comments on the (SVO’s) … "Z" rated bond proposals requiring audited statements … Comments were made relating to … grandfathering certain securities, Canadian municipals exempted from audited statement requirements by the … (SEC), and foreign securities owned in support of foreign liabilities. Commenters were asked (to document) their requests for exemption. The Working Group … adopted a motion stating that the "Z" notation was "intended to be a temporary solution to the problem of obtaining a SVO rating on a fixed income security" and "was never intended to be a basis for avoiding the requirement for obtaining" such a rating …

Industry asked that the Invested Assets (E) Working Group exempt (from the operation of the SVO proposed rule): 1) Municipal securities … issued before July 1, 1995, because the SEC adopted a rule to require issuers to file additional information with municipal and state securities information repositories, often including audited annual financial statements … [making] it likely … audited financial statements will be available … Insurers … have no contractual right to (ask) the issuers (for) audited financials. 2) Adopt the SEC's exemption for municipal issues … (for) $10 million or less in outstanding issues … small communities may not incur the additional cost of having their financial statements formally audited … 3) Modify the … rule (as it applies to) … revenue obligations from issuers without audited financial statements … (because) data [shows] revenue obligations in the 0.5% overall default rate … 4) Review… (the) rule if SVO improvements are inadequate.” NAIC Proceedings 1995, 3rd Quarter at 463, 523, 524

4 “See, NAIC Proceedings 1995, 2nd Quarter at 438, 465 for the original proposal. The original proposal included some of the analytically specific situations that are placed on what we refer to in this memorandum as the third component of the Rule. What follows is the slightly revised proposal submitted by the SVO after receipt on comments on the initial proposal.

“… Proposal: The SVO proposal recognizes the original intent of the Z suffix, (is to permit) … insurers to show investments on their Schedule Ds … purchased too late in the year to receive a value in time from the SVO. The insurer is allowed to self-rate the investment, with their understanding that the investment would be submitted to the SVO for a value within 120 days … securities which held the Z suffix would receive a valid SVO rating by the time the next annual Valuations of Securities manual … SVO management (discovered) that there were a number of insurance companies … using the Z suffix as a way to carry investments on their books for which they had little or no information … To deal with those investments for which the insurers themselves cannot obtain any information, the SVO proposed the following guidelines … The Z suffix will remain as it was intended. … If the security is not submitted to the SVO and a rating obtained within a year's time after the Z designation is applied, the security would then be automatically rated a 5, so long as a letter was received by the SVO from the issuer stating that the issuer was current on its contractual principal and interest payments. If such a letter was not received by the SVO, the issue would either: a) Drop to an NAIC 6 and be priced at Zero; or b) become a nonadmitted asset … There are some exceptions and latitude … spelled out in detail in our original proposal. … The SVO, therefore, requests that the Invested Assets (E) Working Group consider this
modified proposal which is similar to the one presented in St. Louis and send … to the … Working Group for accounting issues … NAIC Proceedings 1995, 3rd Quarter at 532.

5 “… certain barriers exist that will prevent full compliance. Among [them] … lack of authorization in older notes/debentures … (allowing) insurers to pursue obtaining newly requested documents or financials; … In many cases, the (insurer’s) cost … is disproportionate to the income generated. The nature of these securities is such that insurers are virtually certain that they will mature in accordance with their terms … Foreign securities continue to be a vexing issue for the SVO.” NAIC Proceedings 1995, 3rd Quarter, at 534.


8 A third component of the 5*/6* process consists of a series of permitted usages tied to specific analytical situations. All of them restrict the discretion of the SVO to assignment of the non-analytical 5* or 6* symbols instead of the analytical symbols NAIC 5 or 6.

9 The Purposes and Procedures Manual did not directly refer to the sections describing the population to which the phrase structured securities referred because well-known NAIC reliance on NRSRO credit ratings for structured finance was well-known. What is now Part Three (a) and (b), however, always did identify those securities deemed to be within the scope of the “SVO’s Structured Transactions Group.” This phrase that has been used in the Purposes and Procedures Manual for some time before 2011 and is, in fact, still used as shown below.

“(b) Other transactions under Auspices of the SVO Please refer detailed questions about the analytical or other procedures applied to these securities to the SVO Structured Transactions group. (i) Structured Lottery Securities … (ii) Military Housing Bonds … (iii) Credit Tenant Loans … (iv) Replication (Synthetic Asset) Transactions … (v) Catastrophe-Linked Bonds … (vi) Structured Notes … (vii) Residual Tranches of ABS, RMBS and CLOs and CDOs … (viii) Principal Protected Notes (ix) Exchange Traded Funds … (Emphasis added) Source: Purposes and Procedures Manual, published December 31, 2014.

10 See, Part Seven, Section 5 (a) (iv) (B) of the Purposes and Procedures Manual. It is also worth noting that RMBS and CMBS are not, in fact, reported to the SVO or the Structured Securities Group (SSG) but to the NAIC as part of the general insurer financial statement reporting process as part of the limited filing exempt provided in Part Seven, Section 4 c of the Purposes and Procedures Manual. ABS and other securitizations or structured transactions are still subject to credit rating methodology and are CRP-rated filing exemption in Part two, Section 4 9d0 and, therefore, not subject to filing with the SVO or the SSG.

11 Part Two, Section 5 (a)

12 There were a number of regulatory projects concerned with understanding and deciding how to regulate various populations of real estate related securities. One such project began with consideration of credit tenant loans and evolved into an assessment of commercial mortgage-backed securities (CMBS) and real estate investment trusts (REITs). Another project was concerned with how to regulate residential mortgage-backed securities (RMBS).

See NAIC Proceedings, 1995, 2nd Quarter at 418, 442 and 467 for discussions on the project concerned with building a framework for real estate-related securities that encompassed credit tenant loans, as well as REITs and CMBS. Under this project, an initial decision was made that CMBS would be eligible for Schedule D reporting if they are rated by an approved Nationally Recognized Statistical Rating Organization (NRSRO). As early as 1995, under this project, the Task Force determined that CMBS rated by an NRSRO would be eligible for reporting on Schedule D. NAIC 5*, and NAIC 6* was extended to CMBS when the 5*/6* Rule was finalized.

The Task Force was also called upon to address structured securities as a whole (i.e. RMBS, CMBS, asset-backed securities [ABS], collateralized mortgage obligations [CMOs], collateralized debt obligations [CDOs] and collateralized loan obligations [CLOs]) in a separate project in part because the SVO had assigned YES/NO designations to RMBS but could not convert these designations when the new NAIC 1-5 Designation framework was implemented citing lack of analytical capabilities and resource constraints to properly assess credit risk. This project was referred to as the Phase I – III Project, which was concerned with how to provide NAIC Designations to insurer-owned structured securities. See NAIC Proceedings 1996 1st Quarter at 542 (Attachment Five – A) for the SVO proposal. Under the proposal, Phase I involved structured securities assigned monitored credit ratings by NAIC AROs. Insurers would report these to the SVO, and the SVO would convert the ratings into NAIC Designations and into these values in the VOS Database. Phase II involved transactions once rated but where the insurer could not provide evidence of a currently confirmable NAIC ARO rating. RMBS and other securitizations could be assessed by the SVO on the basis of core documents but CMBS could not. Phase III involved RMBS and CMBS transactions never rated by an NAIC ARO. These could be submitted for an NAIC 5*/6* under the third component of the Rule; quoted below. See also NAIC Proceedings 1996, 3rd Quarter Vol I at 762; 1996, 4th Quarter, Vol I at 921 with respect to Phase III and NAIC Proceedings 1998, 2nd Quarter Vol I at 498, 541 – 548, 551

“Other Permitted Uses of Principal and Interest Certification Form and the NAIC 5* and 6* Designations … (ii) Residential Mortgage Backed Security (RMBS) The … Form and the NAIC 5* and 6* Designations may be used in connection with an RMBS that has never been rated by an NAIC ARO as specified in Part Seven, Section 4 (b) (iii) (B) (5) of this Manual. (iii) Commercial Mortgage Backed Securities (CMBS) The … Form and the NAIC 5* and 6* Designations may be used in connection with a CMBS that has never been rated by an NAIC ARO as specified in Part Five, Sections 3 (c) (ii) (F) and 4 (c) (iii) (A) (3) (F) and Part Seven, Section 4 (b) (iii) (B) (6) of this Manual. Purposes and Procedures Manual Dec. 31, 2009, Part Four, Section 3 (h) (ii) and (iii) at Part Four/Page 9

Note: RMBS – Part Seven, Section 4 (b) (iii) (B) (5) stated that RMBS never rated by an NAIC ARO were first subject to the methodology discussed in 4 (b) (iii) (B) (1) Transactions Never Rated by an NAIC ARO, Residential Mortgage Quality Matrix Procedure, or in lieu the insurer could request assignment of an NAIC 5* or 6* (at Pages Seven/ 32 and Seven/36; CMBS - Part Five, Sections 3 (c) (ii) (F) Part Five/Page 9) required unrated CMBS to be filed with the SVO and limited the SVO to assignment of an NAIC 5* or 6*. 4 (c) (iii) (A) (3) (e) provided the same instructions but for annual update filings). Part Seven, Section 4 (b) (iii) (B) (6) is the CMBS component of the same instruction discussed for RMBS above.

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Industrial asked that the Invested Assets (E) Working Group exempt (from the operation of the SVO proposed rule): 1) Municipal securities … issued before July 1, 1995, because the SEC adopted a rule to require issuers to file additional information with municipal and state securities information repositories, often including audited annual financial statements … (all) … Insurers … have no contractual right to (ask) the issuers (for) audited financials. 2) Adopt the SEC’s exemption for municipal issues … (for) $10 million or less in outstanding issues … small communities may not incur the additional cost of having their financial statements formally audited, … 3) Modify the … rule (as it applies to) … revenue obligations from issuers without audited financial statements … data (shows) revenue obligations in the 0.5% overall default rate … 4) Review … (the) rule if SVO improvements are inadequate.”


“The table below shows the $5*/6* RMBS/CMBS population for 2013, filed under the third component of the Rule applicable to financially modeled securities. An enhancement to NAIC systems prevents filers from creating ATFs for the population of securities subject to financial modeling. If an insurer attempts to file an RMBS or a CMBS with the SVO the following message:

**This CUSIP has currently been modeled as either a RMBS or CMBS.**

Refer to the [Structured Securities Initiative Website](#) for additional guidance;

<table>
<thead>
<tr>
<th>Structured</th>
<th>Total Unique CUSIPs</th>
<th>BACV ($million)</th>
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<tr>
<td>RMBS</td>
<td>7</td>
<td>2.9</td>
</tr>
<tr>
<td>CMBS</td>
<td>15</td>
<td>24.5</td>
</tr>
<tr>
<td>Other (ABS, CMO, CLO, etc.)</td>
<td>35</td>
<td>76.2</td>
</tr>
<tr>
<td>Total</td>
<td>57</td>
<td>102.6</td>
</tr>
</tbody>
</table>
MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force
    Members of the Valuation of Securities (E) Task Force

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office

CC: Charles Therriault, Director, NAIC Securities Valuation Office

DATE: January 13, 2015

RE: Discussion – Improvements to NAIC Systems and Rules Governing Insurer Filing of Securities with the SVO

1. Introduction – The SVO is engaged in a wholesale review of its electronic computer system needs and related processes that aim at enhancing the ability of the office to provide high-quality and timely credit and valuation assessments to insurers for securities filed with the SVO. The internal evaluation of SVO computer needs necessarily involves an assessment of the rules set by the Task Force that govern filing of securities because it is necessary to embed the logic of the rules into such systems or into system processes. The filing rules discussed in this memorandum were adopted approximately 20 years ago and designed to function in an environment dominated by physical manipulation of paper documentation. Since the rules discussed herein were adopted, the regulatory filing and reporting process has evolved into a predominantly electronic process. This memorandum identifies the framework of filing rules and how they interact and makes preliminary observations about modifying or eliminating the components of the framework. The SVO believes that a reevaluation of current rules by the Task Force at this time could lead to significant efficiencies to the regulatory process and help increase the NAIC’s ability to support this regulatory process.

2. Background – As a fundamental concept, the SVO can only assess securities when they are filed with the SVO by insurers. Insurers file initial acquisitions and, in subsequent years, they file annual updates. In any year, and as a historical pattern, insurers file annual updates of securities at very low levels from (approximately) January to May. The number of annual update filings...
spikes and then increases significantly in the period beginning June through August. The annual update pattern appears completely unrelated to the fiscal year-end of the issuer of the security as the percentage of annual updates filings for all issuer fiscal year-ends peak in the same months. (See Figure One, Figure Two and Figure Three). This pattern of filing virtually guarantees that SVO resources are under-utilized for a significant time period in any year and then put under tremendous stress for the remainder of the year. The most likely outcome of this pattern is a population of securities technically filed in a given year but not analyzed by the SVO nor assigned an NAIC Designation by year-end.

The only way, really, to ensure a reduction in the number of un-assessed securities at year-end is to change the policies related to the filing deadlines. The goal would be to eliminate both the annual update “wave” described above and to reduce the very lengthy period allowed after a security is acquired to make an initial filing. By altering both deadlines, the SVO staff resources could be better utilized to ensure a high-quality, reliable and timely regulatory product.

The issue by volume is the annual update. The admissible evidence indicates that among any given population of issuers who own a given security, the insurers wait for someone else to file. One way to reduce the flood of filings shown in Figure One is to require insurers to file owned securities for annual updates shortly after the obligor’s financial statements become available. The second issue would be to more precisely identify the insurer that should file new purchases of securities and reduce the permitted filing window.

3. Preliminary Observations – The rules that govern filing today were developed approximately 20 years ago when filing occurred in a paper environment and relied on paper-based processes. While the NAIC and industry have made significant strides toward the development of an electronic filing environment, the filing rules have not been modified since they were initially adopted. What follows is a series of observations to facilitate a discussion on how the process that governs the filing of securities with the SVO can be improved. We emphasize that SVO systems are already designed to prevent multiple filings of a given security, which means only one insurer is required to file any given security and all insurers who own that security can utilize the SVO work product. The observations in this section are based on the discussion in Section 4 and Section 5 below.
All of the rules and processes that govern the filing process should be integrated into a single Part of the *Purposes and Procedures Manual* solely devoted to operational issues. This would increase an understanding of Task Force policies and of the application and operation of the rules.

The 120-Day Rule (which requires filing of newly acquired securities within that time period) should be shortened and the text reworded to communicate that securities be filed not more than 30 days after purchase.

The *Purposes and Procedures Manual* provides that the initial filer of a security is assumed to be the one responsible for filing an annual update. The word “assumed” probably reflects that the initial filer may at some time no longer own the security. The text should be expressed as a requirement. SVO systems can identify this insurer and the time period when its report is due. The SVO should be authorized to designate an insurer who continues to own the security as the “Filer of Record,” the one responsible for filing it in successive periods.

The period of time given to an insurer to file documents with the SVO under the Authorization to File (ATF) process could be eliminated. Instead, insurers would only be considered as having filed an ATF after all required documents had been received and the filing formally “Accepted” through an acknowledgment from the SVO.

Insurers rarely submit Material Credit Event Filings. The SVO monitoring function could be enhanced by modifying appropriate Statement of Statutory Accounting Principles (SSAPs) to require that the insurer demonstrate that the security was filed with the SVO for evaluation as part of the statutory reporting process pertaining to impairment and related accounting processes. The SVO can coordinate analysis with the affected state(s).

The use of the *NR* (not rated) and *UP* (unable to price) administrative symbols could be expanded. The symbols would be assigned to securities when the assigned insurer has not filed the annual update information in the required time period. The SVO would generate and publish lists of *NR* securities throughout the year so insurers that own the identified securities can file information for them. This would ensure that only those securities that no insurer filed for would remain on the list at year-end.

The *Z* symbol and process is intended for use at year-end by an insurer that has filed all necessary documentation within 120 days but not received a reply from the SVO by year-end. The *Z* symbol could instead be assigned by the SVO as part of its year-end process to identify securities the SVO has received in compliance with the filing policies but has not completed it analysis during the year-end process and which the SVO is committed to complete thereafter and disseminate in its Code 99 process.

The portion of the 5*/6* (pronounced “five star six star”) Rule that permits insurers to file certification for securities for which they lack documentation necessary for the SVO to assign an NAIC Designation should be reviewed for relevancy or eliminated.

4. Outline of the Current Operational Framework for Filing Securities with the SVO

a. **Filing Requirement** – Insurance companies are required to report investments to their state insurance departments with NAIC Designations and or Unit Prices. The core reporting instruction is that insurers obtain the NAIC Designations and Unit Prices from the SVO. This instruction is subsequently narrowed by a number of exemptions from filing. The exemptions exempt filing with the SVO but do not exempt from the requirement that the insurer obtain and report an NAIC Designation and Unit Price (Part Two, Section 2 (a) and (d), respectively).

b. **The 120-Day Rule** – An insurer is required to file securities subject to filing with the SVO within **120 days** of the purchase of the security (Part Two, Section 7).

c. **Who Files** – Responsibility for filing a security with the SVO resides with the purchaser. As a general rule, the insurer with the largest dollar investment in a privately placed security is responsible for an initial filing (Part Two, Section 2 (d)), while an annual update is the responsibility of the initial filer (Part Two, Section 11 (a) (ii)).

d. **Preventing Duplicative Filings** – SVO systems are designed to prevent multiple filings of a given security. An insurer that wants to file a security with the SVO will link up to the Integrated Securities Information System (ISIS) component of the VOS Database and request an electronic ATF. When the insurer identifies the CUSIP number for the security, ISIS will search the Valuation of Securities (VOS) Database, the Filing Exempt (FE) Data File and Inquiry Service for the CUSIP.
i. **CUSIP in VOS** – If ISIS finds the CUSIP in the VOS Database with a current year review date, it will deny the ATF request and display a message that the CUSIP/PPN/CINS already exists in VOS. In this case, no other insurer need file the security, and every insurer that owns the security can use the designation and Unit Price shown in the system.

ii. **CUSIP in FE data file** – If the CUSIP/PPN/CINS identifier is not in the VOS Database but is in the FE Data File, ISIS will display a message that the security is FE.

iii. **CUSIP in Inquiry Service** - If the CUSIP/PPN/CINS identifier is not in the VOS Database or the FE Data File but is in Inquiry Service, it means another insurer has already filed an ATF. ISIS will deny the second request to file and display a message that an ATF number has been issued or an ATF filing has been received.

iv. **ISIS Issues ATF** – If the CUSIP is not in the VOS Database, the FE Data File or in Inquiry Service, ISIS will authorize the insurer to file by granting an ATF number (Part Two Sections 2 (d) and 6).

e. **Managing the ATF** – Once an ATF number has been issued, Inquiry Service will display the CUSIP/PPN/CINS identifier, ATF number and the date of ATF expiration or the date the SVO received the ATF submission.

   i. **Exclusive Time Period** – An ATF gives the insurer an exclusive 30-day period to file the completed ATF form and required documentation with the SVO. If the ATF submission is not received at the SVO by the end of the 30-day period, ISIS deletes the CUSIP/PPN/CINS identifier from Inquiry, which permits another insurer to file for an ATF (Part Two Section 2 (d) and 6).

   ii. **InfoReq** – Once the ATF form and documents are received, the SVO will assess the filing for sufficiency and log an InfoReq into Work Flow with a copy to the insurer. A security subject to InfoReq is held without processing for a period **not to exceed 45 days**. On an exception basis, the SVO may grant an InfoReq response extension to the reporting insurance company but not to exceed 90 days in total, with the time period to begin on the date that the InfoReq was issued. If, at the completion of the 45 days, the reporting insurance company has failed to provide the information requested, the SVO will discard the filing, and all documentation submitted with it and Work Flow will reflect that the filing was discarded due to insufficient information (Part Two, Section 10 (b)).

f. **Credit Assessment and Compilation** – A security filed with the SVO with all required documentation within 120 days of purchase will be designated for credit quality and entered into the VOS Database (Part One, Section 3 (f)) and published as part of the next quarterly compilation of insurer-owned securities (Part One, Section 3 (g)).

g. **Credit Surveillance Functions**

   i. **Monitoring** – Once the security has been entered into the VOS Database, it is subject to monitoring by the SVO to permit evaluation of significant financial development affecting the issuer or the security and ensure an accurate designation. (Part One Section 3 (h) (i) (A)) To support this SVO function, insurers are required to file a Material Credit Events Filing, which consists of all information that indicates a change in the credit characteristics of the issuer or a material change in the terms of the agreement (Part Two, Section 11 (b)).

   ii. **Annual Update** – Once the security has been entered into the VOS Database, it is also subject to a complete review on at least an annual basis to ensure the assigned designation is accurate (Part One, Section (h) (ii)). To support this SVO function, any insurance company that owns a security listed in the VOS Database is invited to satisfy subsequent reporting requirements by filing the additional or annual information. The *Purposes and Procedures Manual* provides that the company that has filed the Initial Report is responsible for the annual update filing. But any insurance companies with an interest in a security must submit the information necessary to enable the SVO to complete its annual review (Part Two, Section 11 (a) (ii)).

   iii. **Database Integrity** – The SVO is also instructed to delete from the VOS Database any security that has matured or for which there is a lack of sufficient or timely information (Part One, Section 3 (h) (ii)). SVO systems are programed to
identify securities subject to annual review for which required information has not been submitted. Bonds are assigned the administrative symbol NR, and preferred and common are assigned the administrative symbol UP. An NR or UP security for which required information is not provided by the end of the first quarter following a year-end are deleted from SVO systems.

5. The Special Reporting Instruction

a. 120-Day Rule and Year-End – An insurer must report a security within 120 days of purchase. The expectation appears to be that the security is reported within this time (not at the conclusion of it) and that the SVO is able to assess the credit quality of the security within the time frame. However, insurers are permitted to self-designate securities provided they comply with the 120-day rule reflecting a concern that during year-end an insurer may not both obtain and file necessary documentation and obtain an NAIC Designation from the SVO (Part One, Section 3 (b) (vi)).

b. The Z Process and the 120-Day Rule – Any security that an insurer self-designates must be identified with the administrative symbol Z as a suffix to the designation. The administrative symbol Z communicates that the NAIC Designation reported by the insurance company was determined by the insurer, not the SVO. The use of this symbol is predicated on the assumption that the security designated with a Z will be submitted to the SVO within 120 days of the date the security was acquired. The Z symbol is not used for securities exempt from filing on the basis of credit rating provider (CRP) credit ratings (FE securities) (Part One, Section 3 (b) (v)).

c. The 5*/6* Process – The Special Instruction was originally designed to curtail improper use of the Z symbol. It was thought that requiring the assignment of an NAIC 5/6 equivalent to securities not filed with audited financial statements would help keep the use of the Z symbol as a temporary device used to handle the year-end issue discussed above. If the SVO is assigned responsibility for assigning the Z symbol the original purposes for the 5*/6* mechanism would be eliminated. The Task Force may wish to consider whether the Rule or the text describing it should be modified.
Attachment One

Part One – Purposes, General Policies and Instructions to the SVO

Section 3. Internal Administration

a) General

The staff of the SVO shall be organized in a manner that the NAIC Executive Vice President shall
deam to be the most appropriate and efficient for the conduct of day-to-day credit assessment and
valuation operations, consistent with the resources provided to the office by the NAIC. The staff shall
promulgate such internal administrative procedures, protocols, policies and guidelines, as it shall
deam necessary for the proper execution of its delegated functions. Such procedures, protocols,
policies and guidelines as are promulgated by the staff shall be open to review and oversight by the.

b) Definitions of NAIC Designation Categories, Valuation Indicators, Administrative Symbols and
Conventions

(i) SVO Administrative Symbols

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

(A) SVO analytical department symbols (except for the SVO SCA Companies Group)

All SVO analytical departments except the SVO SCA Companies Group use the
following administrative symbols:

A means that the Unit Price of the share of common or preferred stock has
been analytically determined by the SVO when used in context of an analytical
department other than the SCA Companies Group.

V when used to report a Unit Price for common or preferred stock means the
Unit Price reported was not provided by the SVO or any market or exchange but was
derived by the insurance company itself or from some other source, pending a valuation
analysis by the SVO.

L indicates that the Unit Price given for a share of common or preferred
stock is the price listed on the New York Stock Exchange, the American Stock
Exchange or on the NASDAQ National Market System.

U indicates that the price given for a share of common or preferred stock is
the price listed on any market or exchange, including a foreign exchange, other than the
New York Stock Exchange, the American Stock Exchange or the NASDAQ National
Market System.

NOTE: The Administrative Symbols A, L, U and V which identify the manner or
source of a Unit Price assigned by the SVO, are collectively referred to as Market
Indicators in the NAIC Annual Statement Instructions.

UP means unable to price. This symbol is used with common or preferred
stock and indicates that a current market quotation was not obtainable or was not
deemed reliable by the SVO.
F means that the NAIC Designation, Unit Price or both shown was determined by the reporting insurance company and not by the SVO. Unlike the administrative symbol Z, the F symbol is used by insurers that meet the definitional criteria for a “Sub-paragraph D Company” as defined in Part Three, Section 1(a)(ii)(D)(4) of this Manual, to report ownership of a foreign security for which the company did not have the information necessary to permit the SVO to conduct an assessment or a valuation.

FE means exempt from filing with the SVO and is used by an insurance company to report an NAIC Designation for an exempt security on the NAIC Financial Statement Blank. When reporting a security on its annual or quarterly financial statements, the administrative symbol FE is used with an NAIC 1 through 6 Designation, and in addition, in the case of preferred stock, in combination with the P and RP Valuation Indicators. FE signifies that the reported security meets the criteria set forth in Part Two, Section 4(d) of this Manual and that the NAIC Designation was arrived at by the insurer by converting the NAIC CRP rating(s) into a corresponding NAIC Designation in accordance with the conversion instructions set forth in Part Two, Section 4 (d) (i)(A) and (B) of this Manual and the rating equivalency identified in Section 7(d) (ii) of this Part or by the NAIC in comparing the security with the NAIC CRP rating feeds.

NR means Not Rated. The symbol is used in the VOS Products for bonds and communicates that the information required to arrive at an NAIC Designation is not available to the SVO or that such information was received too late to be processed and reflected in the most current VOS Products. Bonds assigned an NR symbol will be deleted from the VOS Database if any information deficiency is not rectified by the end of the first quarter following the previous year-end.

Z means that the NAIC Designation reported by the insurance company was not derived by or obtained from the SVO, but has been determined analytically by a reporting insurance company. A security designated with a Z must be submitted to the SVO for valuation within 120 days of the date the security was acquired. The Z symbol should not be used for securities that are exempt from filing with the SVO pursuant to Part Two, Section 4(d) of this Manual.

NR* indicates that the security so designated belongs to a class of securities currently under policy review by the NAIC.

Z* follows an NAIC Designation and means that the class of securities cannot be rated by the SVO because the valuation procedure is under regulatory review.

h) Monitoring of VOS Database

...
(ii) **Annual Review**

On at least an annual basis, the SVO shall review all NAIC Designations and Unit Prices assigned by the SVO to securities in the VOS Database in light of the information presented by each issuer's most recent Audited Financial Statements, or other pertinent information, to verify that the assigned NAIC Designation and/or Unit Price is accurate. As necessary, the SVO shall modify such NAIC Designation and/or Unit Price for the previously reported security as changed circumstances may require or delete any security that has matured or as to which there is a lack of sufficient or timely information.

Bonds assigned the administrative symbol NR shall be deleted from the VOS Database if any information deficiency is not rectified by the end of the first quarter following the previous year-end: provided, however, the SVO will not delete any Bond assigned the administrative symbol NR from the VOS Database if an ATF annual update filing for the Bond appears in ISIS and the SVO has received the necessary information required to assign an NAIC Designation to the Bond. If a Bond is not deleted in accordance with the foregoing process in reliance on an annual update ATF that does not contain the necessary information to permit the assignment of an NAIC Designation, the SVO shall subsequently delete that security from the database.

Preferred stock assigned the administrative symbol UP shall be deleted from the VOS Database if any information deficiency is not rectified by the end of the first quarter following the previous year-end: provided, however, the SVO will not delete any preferred stock assigned the administrative symbol UP from the VOS Database if an ATF annual update filing for the Bond appears in ISIS and the SVO has received the necessary information required to assign a valuation and/or NAIC Designation to the preferred stock. If a preferred stock is not deleted in accordance with the foregoing process in reliance on an annual update ATF that does not contain the necessary information to permit the assignment of a valuation and/or NAIC Designation, the SVO shall subsequently delete that security from the database.

Common stock assigned the administrative symbol UP shall be deleted from the VOS Database if any information deficiency is not rectified by the end of the first quarter following the previous year-end: provided, however, the SVO will not delete any common stock assigned the administrative symbol UP from the VOS Database if an ATF annual update filing for the common stock appears in ISIS and the SVO has received the necessary information required to assign an NAIC Designation to the common stock. If a common stock is not deleted in accordance with the foregoing process in reliance on an annual update ATF that does not contain the necessary information to permit the assignment of a valuation, the SVO shall subsequently delete that security from the database.

**Part Two – Filing With the SVO**

**Section 1. General Definitions Used in This Manual**

The following definitions are intended to have relevance only for this Manual. No suggestion is intended that these definitions have any relevance to any other NAIC publication.

**Authorization to File (ATF)** means the component of ISIS that permits reporting insurance companies to file a security with the SVO.
Automated Valuation Service (AVS) means a subscription service offered by the NAIC permitting access to portions of the VOS Database and showing updated Association Values prior to publication in the VOS Products.

Initial Report means the report and documentation filed with the SVO by a reporting insurance company as discussed in Section 10(a) of this Part below.

InfoReq means an information request sent by the SVO to a reporting insurance company detailing informational deficiencies associated with an Initial or a Subsequent Report, as discussed in Section 11 of this Part below.

Inquiry Service means the reporting insurance company's view of the Work Flow component of ISIS.

ISIS stands for Integrated Securities Information System and refers to the SVO's electronic computer system for reporting and tracking securities.

SIC Code stands for Standard Industrial Code and refers to a 4-digit classification scheme established by the U.S. Department of Commerce for organizing commercial entities by industry specialization.

Subsequent Report means the report and documentation filed with the SVO by a reporting insurance company as discussed in Section 11 of this Part below.

SVO stands for the Securities Valuation Office of the NAIC and refers to the portion of the Executive Headquarters that serves as the professional staff of the Valuation of Securities (E) Task Force (VOS/TF).

Unit Price means the value determined for a security by the SVO pursuant to Part Five, Section 1 of this Manual for purposes of valuation under SAP.

VOS Database means the Valuation of Securities Database and refers to that component of the SVO's Integrated Securities Information System (ISIS) used to store the names and descriptions of securities owned by state-regulated insurance companies, together with the NAIC Designation categories and/or Unit Price assigned to them.

VOS Products refers to the quarterly compilation of information derived from the VOS Database, the FE Datafile, Unit Prices assigned by the SVO and Unconfirmed FE’s.

Work Flow means the component of the SVO's Integrated Securities Information System (ISIS) that tracks submission and status of all Initial and Subsequent Reports filed by, or on behalf of, reporting insurance companies.

Section 2. General Reporting Framework

d) Reporting Responsibilities

Reporting is the responsibility of the insurance company that has purchased the investment. There are procedures that reduce multiple reporting on the same securities by different insurance companies. These procedures are discussed below.

As a general rule, the reporting of privately placed securities is the responsibility of the insurance company lender with the largest dollar investment in the transaction. Also, only previously unreported investments need be reported to the SVO. To ascertain whether another insurance company has previously reported a security to the SVO, the reporting insurance company should consult the most recent VOS Products, the Automated Valuation Service or Inquiry Service.

No reporting is necessary if the security (i) is listed in the VOS Products with a recently assigned NAIC Designation/Unit Price, (ii) is listed in the Automated Valuation Service with a current year
review date and a symbol that is other than an NR or UP or (iii) has been logged into Inquiry Service.

f) Security Identification Numbers

No security may be reported to the SVO without a valid CUSIP, PPN or CINS Identifier. Only S&P CUSIP may assign CUSIP Identifiers, PPNs and CINS.

To obtain filing and fee information and a CUSIP Identifier, PPN or CINS number, reporting insurance companies must contact S&P CUSIP at: CUSIP Service Bureau, Standard & Poor's Corporation, Attention: Senior Copy Editor, 55 Water Street, 47th Floor, New York, N.Y. 10041, e-mail address is cusip_ppn@standardandpoors.com, Facsimile (212) 438-6572.

Section 5. Special Reporting Instruction

a) NAIC Designations Related to the Special Reporting Instruction

NAIC 5* is assigned by the SVO to certain obligations when an insurer certifies: (1) that documentation necessary to permit a full credit analysis of a security does not exist and (2) the issuer or obligor is current on all contracted interest and principal payments and (3) the insurer has an actual expectation of ultimate payment of all contracted interest and principal. This use of an NAIC 5* Designation is connected with the Special Reporting Instruction contained in Section 5(b) of this Part below. The NAIC 5* Designation is also assigned to certain securities pursuant to policy decisions adopted by the Valuation of Securities Task Force. Securities with NAIC 5* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. Therefore a security assigned an NAIC 5* Designation should incur the same regulatory treatment associated with an NAIC 5 Designation. The asterisk (*) after the quality indicator 5 distinguishes the NAIC 5* Designation from the NAIC 5 Designation that is only assigned by the SVO after a full credit analysis.

NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation to the SVO for a full credit analysis or filing the certification required for obtaining an NAIC 5* Designation. This use of an NAIC 6* Designation is connected with the Special Reporting Instruction contained in Section 5(b) of this Part below. An NAIC 6* Designation is also assigned by the SVO to an obligation that was assigned an NAIC 5* Designation in a given year if no Subsequent Report is received by the SVO. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore a security assigned an NAIC 6* Designation should incur the same regulatory treatment associated with an NAIC 6 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation that is only assigned by the SVO after a full credit analysis.

b) Special Reporting Instruction – Use of the Administrative Symbol Z Schedule D

An insurance company may report a security with a “Z” suffix on its Schedule D for up to a year after purchase. For the second year after purchase, and thereafter, the insurance company may not report a security with a “Z” suffix except as noted in Section 5(d) of this Part below.

The insurer shall either file the security and appropriate documentation with the SVO to obtain an NAIC Designation, file a Principal and Interest Certification Form to obtain an NAIC 5* Designation or report the security with an NAIC 6* Designation on its Schedule D (collectively, the “5*/6* Rule”).
An insurance company that decides to file a Principal and Interest Certification Form for a security, pursuant to the 5*/6* Rule, should do so by October 1.

c) Application of the 5*/6* Rule

Insurers are required to apply the 5*/6* Rule to all Annual Statements beginning with the 1999 Annual Statement. The 5*/6* Rule applies only to securities owned in the prior year. For example, in the 1999 Annual Statement filing, the 5*/6* Rule would have applied to securities that had been listed with a “Z” as of December 31, 1998.

d) Exemption from Application of the 5*/6* Rule

The 5*/6* Rule will not be held to apply to a security that has been:

(i) Filed in a timely manner after purchase of such security (that is, within 120 days), and
(ii) For which a complete filing (including any annual filing that would have been required if the original filing had received an NAIC Designation) is received by the SVO by September 1, if the SVO has not reviewed such security by year-end.

For these securities, a “Z” suffix is reported on Schedule D.

e) Documentation

Insurance companies are instructed to maintain a record of the purchase and filing dates of the securities they file with the SVO.

f) Use of NAIC 5* Designation

An insurer may file a Principal and Interest Certification Form with the SVO when it can certify:

(i) That documentation necessary to permit a full credit analysis of a security does not exist;
(ii) The issuer or obligor is current on all required interest and principal payments; and
(iii) The insurer has an actual expectation of ultimate payment of all required interest and principal.

The SVO may assign the NAIC 5* Designation to corporate, municipal and to structured securities that have never been rated by an NAIC CRP.

An NAIC 5* Designation can only be assigned by the SVO. The SVO shall assign an NAIC 5* Designation upon a review of a fully completed and executed Principal and Interest Certification Form.

The submission of the Principal and Interest Certification Form does not preclude the SVO from conducting an analytical review of the security. Upon such review, in cases where assigning an NAIC 5* Designation appears inconsistent, the SVO shall apply appropriate analytical procedures to assure an accurate designation.

The SVO is not responsible for assessing the truth or accuracy of the Principal and Interest Certification Forms that are filed by insurers or for monitoring any other aspect of this Special Reporting Instruction.

g) Use of NAIC 6*Designation
An insurer may assign an **NAIC 6* Designation** to corporate and municipal securities and to structured securities that have never been rated by an NAIC CRP.

The insurer shall assign an **NAIC 6* Designation** to a security when:

(i) The documentation necessary to permit a full credit analysis of a security does not exist;
(ii) The insurer cannot certify that the issuer or obligor is current on all required interest and principal payments; and
(iii) The insurer cannot certify that it expects ultimate payment of all interest and principal.

The SVO may assign a security an **NAIC 6* Designation** when the security was assigned an **NAIC 5* Designation** in a previous year but no Subsequent Report has been received by the SVO.

**h) Unit Price of NAIC 6* Securities**

An insurer that intends to report a security on its annual or quarterly financial statement (NAIC Financial Statement Blank) with an **NAIC 6* Designation** and a Unit Price not greater than zero is not obligated to file a Principal and Interest Certification Form for the security with the SVO. An insurer that intends to report a security on its annual or quarterly financial statement (NAIC Financial Statement Blank) with an **NAIC 6* Designation** and a Unit Price greater than zero shall file a Principal and Interest Certification Form for the security with the SVO.

**i) Other Permitted Uses of the Principal and Interest Certification Form and the NAIC 5* and 6* Designations**

(i) **Corporate Bonds and Preferred Stock with Unaudited Financial Statements**

The Principal and Interest Certification Form and the **NAIC 5* Designation** may be used in connection with the designation of corporate securities with unaudited financial statements as specified in Part Three, Section 1(a)(ii)(B) of this Manual.

(ii) **Residential Mortgage Backed Security (RMBS)**

The Principal and Interest Certification Form and the **NAIC 5* and 6* Designations** may be used in connection with an RMBS that has never been rated by an NAIC CRP as specified in Part Seven, Section 5(a)(iv)(B) of this Manual.

(iii) **Commercial Mortgage Backed Securities (CMBS)**

The Principal and Interest Certification Form and the **NAIC 5* and 6* Designations** may be used in connection with a CMBS that has never been rated by an NAIC CRP as specified in Part Seven, Section 5(a)(iv)(B) of this Manual.

(iv) **Foreign Securities of Issuers Domiciled with No NAIC CRP Sovereign Rating**

The Principal and Interest Certification Form and the **NAIC 5* and 6* Designations** may be used in connection with reporting foreign securities issued in countries that have not been assigned a sovereign rating by an NAIC CRP as specified in Part Three, Section 1(a)(ii)(D)(2) of this Manual.

(v) **Parent-Subsidiary Situations**

The Principal and Interest Certification Form and the **NAIC 5* and 6* Designations** may be used in connection with reporting parent-subsidiary situations as specified in Part Three, Section 1(a)(ii)(E) of this Manual.
(vi) Military Housing Bonds or Securities Issued On or After Dec. 31, 2009 and Not Rated by an NAIC CRP
The Principal and Interest Certification Form and the NAIC 5* Designation may be used in connection with the designation of military housing bonds or securities that were issued on or after Dec. 31, 2009, and were not rated by an NAIC CRP pursuant to the policy determination expressed in Part Four, Section 5(c) of this Manual.

(vii) Other Catastrophe-Linked Bonds
The Principal and Interest Certification Form may be used to report a Catastrophe-Linked Bond that has not been assigned a credit rating by an NAIC CRP and those that have been assigned a credit rating by an NAIC CRP on the basis of a methodology other than that specified in Part Four, Section 4 (a) (iii) of this Manual.

Catastrophe-Linked Bonds not assigned a credit rating by an NAIC CRP and those assigned a credit rating by an NAIC CRP on the basis of a methodology other than that specified in Part Four, Section 4 (a) (iii) of this Manual shall be reported to the SVO and assigned an NAIC 6* Designation by the SVO.

Section 6. The Mechanics of Reporting With the SVO

Determining whether a security subject to reporting under Section 2(a) of this Part above has been reported to the SVO is accomplished through a computer link up with SVO's Integrated Securities Information System (ISIS). If the security has not been previously reported to the SVO and is not known to be exempt, ISIS will assign an Authorization To File (ATF) number at the end of the ATF process. The reporting entity receiving an ATF number must then file the completed ATF form and required documentation with the SVO office. The following is a summary description of the steps in the reporting confirmation process.

(a) Link to ISIS
(b) Login by presenting appropriate username and password
(c) Go to the Authorization to File (ATF) process
(d) Enter the valid CUSIP/PPN/CINS identifier of the security to be reported. ISIS will then process that security based on its identifier:

(i) Already Contained in VOS Database:
If the CUSIP identifier is found in the VOS database with a current year review date, ISIS will deny the reporting entity's request to file an initial or subsequent report and display a message that the CUSIP/PPN/CINS already exists in VOS. If so, this ends the reporting process for that security.

(ii) Previously Reported/ATF Already Issued:
(A) If the CUSIP/PPN/CINS identifier does not exist in the VOS database but is found in Inquiry Service due to reporting by another reporting entity, ISIS will deny the entity's request to file an initial or subsequent report and will display a message that an ATF number has been issued or an ATF filing has been received.

(B) If an ATF number has been issued, Inquiry will display the CUSIP/PPN/CINS identifier, ATF number, and the date of ATF expiration or the date the SVO received the ATF submission.

(C) If the ATF submission is not received at the SVO by the ATF expiration date, ISIS will delete the CUSIP/PPN/CINS identifier from Inquiry. If this occurs, it is the responsibility of the reporting entity to re-report the security.
(D) If an ATF submission has been received at the SVO, this ends the reporting process for that security.

(iii) Already Deemed to be Filing Exempt:
(A) If the CUSIP/PPN/CINS identifier is found in the Filing Exempt data file, ISIS will display a message that informs the entity that the security is Filing Exempt.
(B) The entity is then given the option to continue the ATF process in spite of the security’s FE status (for instance, if required by a state regulator). If the answer is “No” that ends the reporting process for that security.

(iv) Not Yet Deemed to be Filing Exempt:
(A) If the CUSIP/PPN/CINS identifier is not found in the Filing Exempt data file, the reporting entity may request through ISIS that the security be run through the filing exempt application. This can be done even if the security is found in the VOS database or Inquiry Service.
(B) ISIS will search the NAIC CRP feeds for a match and, if a match is found, the application will translate the NAIC CRP ratings into the equivalent NAIC designation, which will be available in the subsequent FE data file. The reporting entity will have to access the FE data file contained within AVS on the following day in order to view the equivalent NAIC designation.
(C) The entity is then given the option to continue the ATF process in spite of the security’s FE status (for instance, if required by a state regulator). If the answer is “No,” that ends the reporting process for that security.

(v) Filing Required:
(A) If the CUSIP/PPN/CINS identifier entered by the reporting entity is not Filing Exempt, in VOS, or in Inquiry Service, ISIS will grant the filer access to a series of menu options designed to permit the entity to bring up the appropriate ATF filing form on its personal computers, fill out necessary information and generate a hard copy form of the ATF for filing with the SVO.
(B) ISIS will permit the reporting entity to access, electronically, all of the forms that are required to be filed with the SVO, (with the exception of the Application for Regulatory Treatment Analysis Service, which can only be submitted on an original hard copy form obtained from the SVO). The printed ATF and other applicable forms are then to be forwarded to the SVO with the required documentation for the security within 120 days of the triggering event. The reporting process for this security is complete when the ATF submission and filing has been received by the SVO.
(C) When the ISIS processing of a security is complete (an ATF is either issued or denied), ISIS will ask the entity if it wishes to enter the CUSIP/PPN/CINS identifier of a new security. If you have a question about filing requirements for a given security, consult the How To Comply Manual, which is available from the NAIC Publications Department. See the notice at the end of the table of contents.

Section 7. When to Use the Securities Acquisition Report (SAR)

A security issued by an entity unaffiliated with the reporting company is reported by creating, completing and submitting the SAR form. The reporting insurance company must submit the SAR to the SVO not later than 120 days after the purchase of the security.
a) SIC Code

As an internal administrative matter, for all Corporate securities, the SVO will distribute Initial and Subsequent Reports in accordance with the industry specialization of SVO's credit analysts. Therefore, the Industry Code identified on the SAR must be accurate. The reporting insurance company chooses the correct Industry Code from a menu embedded in ISIS. Only the first two digits of the Code itself are necessary for SVO purposes. For example, the SIC Code for a luggage manufacturing company is 3160 but, for SVO purposes, the SIC Code 3100 (Leather and Leather Products) is sufficient. The SVO Help Desk will provide assistance in determining the correct SIC Code.

Section 10. Reporting Conventions and Required Documents

a) Initial Report

An initial filing consists of a completed form(s) and information, documentation and data in quantity and quality sufficient to permit the SVO to conduct an analysis of the creditworthiness of the issuer and the terms of the security to determine an Association Value. It is the obligation of the reporting insurance company to provide the SVO with all necessary information. It is the responsibility of the SVO to determine whether the information provided is sufficient and reliable for its purposes and to communicate informational deficiencies to the reporting insurance company.

b) Informational Deficiencies

Upon receipt of a submission by a reporting insurance company, the submission is logged into Work Flow by date and time received and assigned to the appropriate staff analyst for credit assessment or unit pricing. If the staff analyst determines that there is an informational deficiency, he or she will complete an InfoReq letter, log the InfoReq into Work Flow and provide a copy to the reporting insurance company.

The transaction for which the InfoReq was issued will be held without processing for a period not to exceed 45 days. If, at the completion of the 45 days, the reporting insurance company has failed to provide the information requested, the SVO will discard the filing and all documentation submitted with it and Work Flow will reflect that the filing was discarded due to insufficient information.

On an exception basis, the SVO may grant an InfoReq response extension to the reporting insurance company but not to exceed 90-days in total with the time-period to begin on the date that the InfoReq was issued. If such an extension is granted, and if the reporting insurance company has failed to provide the information requested within the time provided, the SVO will discard the filing and all documentation submitted with it at the end of the 90-day period and Work Flow will reflect that the filing was discarded due to insufficient information.

Either at the expiration of the 45-day or 90-day period InfoReq response period, the reporting insurance company shall be obligated to file the security again if it wishes to obtain an NAIC Designation.

If the SVO determines it requires additional information after an InfoReq response has been received, a new 45-day period shall being, unless an InfoReq response extension is granted as indicated above, in which case a new 90-day period will begin.

Section 11. Subsequent Reporting
a) Annual Filing Requirement

(i) Filing Exempt Securities

No subsequent report is required for the purposes of valuation of securities under Part Five, Section 1 of this Manual and no subsequent report is required for filing exempt securities unless they no longer qualify as filing exempt. Instructions for filing exempt securities are detailed in Section 4(d) of this Part.

(ii) All Other Securities

Any insurance company that owns a security listed in the VOS Database, which is not filing exempt as set forth in Section 4(d) of this Part above can satisfy subsequent reporting requirements by filing the additional or annual information described below. For purposes of this Manual, it is assumed that reporting responsibility is borne by the company that has filed the Initial Report. However, the SVO recognizes the possibility that the initial reporting insurance company may have sold its investment. Therefore, any insurance companies with an interest in a security may need to submit the information necessary to enable the SVO to complete its annual review. Annual filings should be reported to the SVO on the Annual ATF.

b) Material Credit Events Filing

It is the responsibility of the reporting insurance company to file all information that indicates a change in the credit characteristics of the issuer or a material change in the terms of the agreement.

What constitutes a material change will vary in accordance with the nature of the transaction. For purposes of this subsection, a material credit event is any occurrence that affects or is substantially likely to affect the issuer's ability to pay the obligation in accordance with its terms.

A determination that a bond is impaired for purposes of SSAP No. 26 is a material credit event under this subsection. Accordingly, when an insurer determines that a bond is impaired under SSAP No. 26, it shall file relevant information with the SVO under this subsection.

Material events should be reported to the SVO on the Material Change/Additional Information ATF. The SVO assumes that the information filed will be accurate and will reflect all information relevant to the material event in the possession of the reporting insurance company. The SVO will not audit the information submitted by the insurance company.
MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force
    Members of the Valuation of Securities (E) Task Force

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office

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

DATE: January 5, 2015


1. Background – During the NAIC 2014 Spring National Meeting, the Investment Analysis Office introduced an amendment to collect all text in the Purposes and Procedures Manual that referred or pertained to financial modeling or to the Structured Securities Group (SSG) in a new Part Seven. The proposed amendment included new text that referred to the newly formed SSG, but some of the text that was being consolidated into Part Seven referred to the SVO and reflected that it conducted the year financial modeling project prior to the formation of the SSG. Because the focus was on creating a new Part Seven, no effort was made to comprehensively modify references to the SVO or the SSG to more accurately refer to the staff that would perform the activity described in portions of the text. The Task Force adopted the proposal to create Part Seven of the Purposes and Procedures Manual on June 19, 2014. The amendment proposed in this memorandum would modify some references to the SVO and or SSG to more accurately identify which NAIC staff (SVO and SSG) are involved in the activity. The staff request that the proposal be received and released for a 45-day comment period.
Section 1. The NAIC Structured Securities Group

The NAIC has determined that it is necessary to establish a function to provide NAIC members with an internal analytical capability to assess risks associated with insurer-owned securitizations and other complex financially engineered securities. The SSG is established as the function assigned to assess credit and other investment risks in securitizations and other complex financially engineered securities owned by state-regulated insurance companies.

Section 2. Definitions

The following terms used in this Part Seven have the meaning ascribed to them below.

ABS stands for asset-backed securities and means structured securities backed by consumer obligations originated in the United States.

CMBS stands for commercial mortgage-backed securities and means structured securities backed by commercial real estate mortgage loans originated in the United States. The definition of CMBS may refer to securitizations backed by commercial mortgages, respectively, originated outside of the United States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: 1) has the necessary information about the commercial mortgage and commercial mortgage loans originated outside of the United States to fully model the resulting securities; and 2) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.

Initial Information means the documentation required to be filed with an Initial Filing of an RMBS or a CMBS CUSIP, pursuant to Section 6 below and pertaining to Loan Information, Reps and Warranty Information and Structure and Formation Information for the transaction, where:

- Loan Information means a review of the loan files by a third party to assess the sufficiency of legal title and other related issues;
- Reps and Warranty Information means the actual representation and warranties in effect for the securitization given by the mortgage originator(s) to the Trust pertaining to loan origination processes and standards, compliance with applicable law, loan documentation and the process governing put backs of defective mortgages back to the originator(s); and
- Structure and Formation Information means the waterfall, as described in the definition of Ongoing Information, information and documentation in the form of legal opinions and documentation governing the formation of the securitization and its entities relative to issues such as bankruptcy remoteness, true sale characterization, the legal standards and procedures governing the securitization and other similar issues.

Legacy Security, for the purposes of this [section] shall mean any RMBS and any CMBS that closed prior to Jan. 1, 2013.

Ongoing Information consists of: a) tranche level data; such as principal balance, factors, principal and interest due and paid, interest shortfalls, allocated realized losses, appraisal reductions and other similar information for the specific tranche, b) trust level data, such as aggregate interest and principal and other payments received, balances and payments to non-trance accounts, aggregate pool performance data and other similar information; c) loan level performance information; and; d) a computerized model of rules that govern the order and priority of the distribution of cash from the collateral pool (“i.e., the waterfall”) to the holders of the certificates/securities provided in the format and modeling package used by the NAIC financial modeling vendor.

Original Source, with respect to a specific set of data, means the Trustee, Servicer or similar entity that is contractually obligated under the agreement governing the RMBS or CMBS to generate and maintain the relevant
data and information in accordance with standards specified in applicable agreements or an authorized re-distributor of the same.

**Re-REMIC** is a securitization backed by (i) otherwise eligible RMBS from one or two transactions; or (ii) otherwise eligible CMBS from one or two transactions at closing. Re-REMICs cannot acquire any Underlying Securities after closing.

**RMBS** stands for *residential mortgage-backed securities* and means structured securities backed by non-agency residential mortgages originated in the United States, where the collateral consists of loans pertaining to non-multi-family homes. That includes prime, subprime and Alt-A mortgages, as well as home-equity loans, home-equity lines of credit and Re-REMICs of the above. Excluded from this definition is agency RMBS, where the mortgages are guaranteed by federal and federally sponsored agencies such as the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC) and loans against manufactured or mobile homes or collateralized debt obligations backed by RMBS. The exclusion covers bonds issued and guaranteed by, or only guaranteed by, the respective agency. Also not included are loans guaranteed by the U.S. Department of Veteran Affairs or the U.S. Department of Agriculture’s Rural Development Housing and Community Facilities Programs. The definition of RMBS may refer to securitizations backed by residential mortgages, respectively, originated outside of the Unites States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: 1) has the necessary information about the residential mortgage and residential mortgage loans originated outside of the United States to fully model the resulting securities; and 2) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.

**Underlying Security** means the RMBS or CMBS backing a Re-REMIC. A Re-REMIC cannot be an Underlying Security.

**NOTE:** The definitions of RMBS and CMBS reflect limitations associated with the financial modeling process, NAIC credit rating provider (CRP) internal naming conventions and SSG SVO-processes, as more fully discussed below and may, therefore, be subject to a narrower or a broader reading in any reporting period. Please call the SSG SVO with any concerns or questions about the scope of the definitions for a given reporting period.

- It is possible that the scope of the RMBS and CMBS definitions may be broadened because the financial modeling vendors indicate other collateral or waterfall structures can be modeled.
- NAIC CRPs may adopt different internal conventions with respect to what market or asset segments are within their rated populations of RMBS, CMBS or ABS. This could affect the application of the adopted NAIC methodology or require the NAIC to select which naming process it wishes to adopt.
- It is possible that the SSG SVO will acquire analytical assessment capabilities that permit the assessment of existing, additional or different structured securities that cannot now be modeled or that are not currently rated.

**Price Grids** means and refers to CUSIP-CUSIP-specific price matrices containing six price breakpoints; i.e., each price corresponding to a specific NAIC Designation category. Each breakpoint on a Price Grid is the price point that tips the NAIC Designation for the RMBS CUSIP into the next NAIC Designation (credit quality/credit risk) category. The plural is used because two Price Grids are generated for any CUSIP. This reflects the difference in RBC for those insurance companies that maintain an asset valuation reserve and for those insurance companies that do not.
Official Price Grids means and refers to those generated by the SSG and provided to an insurance company or insurance companies that own the security for regulatory reporting purposes.

Section 3. Policies Defining the NAIC Structured Securities Group

a) Directive to Conduct Ongoing Operations

The SSG shall conduct the following ongoing operations:

(i) Develop and maintain expertise related to securitizations, including, but not limited to, knowledge of: market developments; issues and concerns related to applicable law; accounting regimes; structures including waterfall arrangements, governing the cash flows and performance characteristics of different types of collateral; and the financial modeling and other technology relevant to assessing their valuation and risk assessment;

(ii) Collaboration with the SVO to assess credit and other risks in non-securitizations, including for the purpose of assigning NAIC Designations;

(iii) Collaboration with other NAIC Staff functions to facilitate related regulatory objectives;

(iv) Such other analytical assignments assigned or requested by the VOSTF or other NAIC regulator group;

pursuant to and in accordance with, the directives, procedures and instructions described in this Part Seven and those generally applicable to the SVO or other Staff functions in this Manual and other applicable NAIC guidance.

b) SSG Regulatory Products

(i) NAIC Designations

The SSG is authorized to assign NAIC Designations.

(ii) NAIC 5*/6* Designations

The SSG is authorized to assign NAIC 5*/6* Designations to RMBS and CMBS under the Special Reporting Instruction contained in Part Two, Section 5 of this Manual as part of the administration of the annual surveillance discussed in Section 6 (a) of this Part and as may be subsequently authorized.

(iii) Price Grids

The SSG shall generate Price Grids as required for the annual surveillance specified below in Section 6 (a) of this Part; in the exercise of its responsibilities under the Regulatory Treatment Analysis Service (RTAS) as specified in Section 6 (c) below, or as shall otherwise be necessary in fulfillment of an assigned responsibility.

c) Other Applicable Policies – Application of Analytical Instructions; Responsibility for Investment Risk Analysis in New Financial Products; Process for Placing Securities Under Regulatory Review

The policies and instructions specified in Part One, Section 2 (d), 2 (e) and 2 (f) of this Manual made applicable to the SVO shall be also fully applicable to the SSG, allowing for differences inherent in structured securities, analytical assignment given to the SSG and methodologies to be applied by it.

Section 4. Administrative and Operational Matters
a) **Certain Administrative Symbols**

The following administrative symbols are used in the *Valuation of Securities (VOS)* Products to identify RMBS and CMBS that the NAIC vendor has confirmed will be subject to the financial modeling methodology described in Section 6 (a) of this Part.

- **FMR** indicates that the specific CUSIP identifies an RMBS that is subject to the financial modeling methodology.
- **FMC** indicates that the specific CUSIP identifies a CMBS that is subject to the financial modeling methodology.

The use of these administrative symbols in the VOS Product means the insurer should not use the filing exempt process specified in Part Two, Section 4 (d) of this Manual for the security so identified.

**NOTE:** The administrative symbols FMR and FMC are related to symbols that insurers are required to use in the financial statement reporting process. Under applicable financial statement reporting rules, an insurer uses the symbol:

- **FM** – as a suffix to identify modeled RMBS and CMBS CUSIPs;
- **AM** – as a suffix to identify CUSIPs not modeled and not designated by the SVOSSG, but for which CRP ratings were used to derive the NAIC Designation.

The symbols FM and AM are inserted by the insurer in the financial statement as a suffix in front of the NAIC Designation category—i.e., 2FM.

b) **Quarterly Reporting of RMBS and CMBS**

To determine the NAIC Designation to be used for quarterly financial statement reporting for an RMBS or CMBS purchased subsequent to the annual surveillance described in Section 6 (a) of this Part, the insurer uses the prior year-end modeling data for that CUSIP (which can be obtained from the NAIC) and follows the instructions in Section 6 (a) (iii) (3) (a) (v) of this Part Seven below or follows the instructions in Section 6 (a) (iv) of this Part Seven below, subject to, and in accordance with, SSAP No. 43R—.

c) **Filing Exemptions**

(i) **Limited Filing Exemption for RMBS and CMBS**

(A) **RMBS and CMBS that can be Financially Modeled.**

RMBS and CMBS that can be financially modeled are exempt from filing with the SVO.

NAIC Designations for RMBS and CMBS that can be financially modeled are determined by application of the methodology discussed in Section 6 (a) (iii) of this Part Seven, not by the use of credit ratings of CRPs.

(B) **RMBS and CMBS securities that cannot be Financially Modeled**

(1) But are rated by a CRP

RMBS and CMBS that cannot be financially modeled but that are rated by a CRP are exempt from filing with the SVOSSG—. The NAIC Designations for these RMBS and CMBS are determined by application of the modified filing exemption discussed in Section 6 (c) (iv) (A) of this Part Seven.
(2) But are not rated by an CRP
RMBS and CMBS that cannot be financially modeled and that are not rated by a
CRP are not filing exempt and must be filed with the SVOSSG, as discussed
below in Section 6 (a) (iv) (B) of this Part Seven. See also, Part Two, Section 5
(i) of this Manual.

(ii) Filing Exemption for ABS
ABS rated by a CRP are exempt from filing with the SSG pursuant to the filing
exemption contained in Part Two, Section 4(d) of this Manual.

d) Review of Decisions of the SSG
Analytical decisions made through the application of financial modeling are not subject to the
appeal process specified in Part One, Section 2 (g) of this Manual. In the absence of an appeal,
the SSG shall provide whatever clarification as to the results of financial modeling is possible
to any insurer who requests it and owns the security, provided that it is not unduly burdensome
for the SSG to do so. Any decision made by the SSG that results in the assignment of an NAIC
Designation and does not involve financial modeling methodology, whether developed by the
SSG on its own or in collaboration with the SVO, is subject to the appeal process in Part One,
Section 2 (g) of this Manual.

Section 5. Required Data and Documents for Transactions Submitted to the SSG

a) General Policy on Required Data and Documentation
The policy statement set forth in this Section 5 (a) shall be applicable generally to any
transaction filed with the SSG for an analytical assessment, including, but not limited to, a
Price Grid or for assignment of an NAIC. Any filing with the SSG is deemed to be incomplete
unless the insurer has provided the information, documentation, and data in quantity and
quality sufficient to permit the SSG to conduct an analysis of the creditworthiness of the issuer
and the terms of the security to determine the requested analytical value. It is the obligation of
the reporting insurance company to provide the SSG with all necessary information. It is the
responsibility of the SSG to determine whether the information provided is sufficient and
reliable for its purposes and to communicate informational deficiencies to the reporting
insurance company.

b) Documentation Standards and Procedure for Annual Surveillance of RMBS and CMBS

(i) Documentation Standard
In order for an insurer-owned RMBS or CMBS to be eligible for the year-end
modeling process, conducted pursuant to this Part Seven, Section 6 (a) below, the
analysis must be based on information, documentation and data of the utmost integrity.

A Legacy Security must meet the Ongoing Information requirements.

An RMBS, CMBS or Re-REMIC that is not a Legacy Security must meet the Initial
Information and Ongoing Information requirements. For the purposes of determining a
Re-REMIC’s status as a Legacy Security, the closing date of the Re-REMIC (not the
Underlying Security) shall be used.

The SSG may, in its sole discretion, determine that the Initial Information and/or
Ongoing Information is not sufficient and/or not reliable to permit the RMBS or
CMBS CUSIP to be eligible for financial modeling. If the SSG determines that the
Initial Information and/or Ongoing Information is not sufficient and/or not reliable to permit the RMBS or CMBS CUSIP to be eligible for financial modeling, it will communicate this decision to the insurer and invite a dialogue to ascertain whether alternative information is available that would be deemed sufficient and/or reliable by the SSG.

(ii) Initial Information Requirements

An RMBS or CMBS meets the Initial Information Requirements if the security meets one of the following three conditions:

1. **RTAS.** The RMBS or CMBS was assigned a preliminary price grid or designation as described in this Part Seven;

2. **Initial Sufficiency Filing.** The RMBS or CMBS was reviewed by SSG through an Initial Sufficiency Filing; or

3. **Safe Harbor.** The RMBS or CMBS meets the Safe Harbor requirements

**A Initial Sufficiency Information Filing**

An insurance company may file Initial Sufficiency Information with the SSG for the purpose of obtaining a determination that an RMBS or CMBS CUSIP is eligible for financial modeling under the annual surveillance process discussed in Section 8(iii) below.

Initial Sufficiency Information is only filed once for any given RMBS or CMBS. Reporting insurance companies are solely responsible for providing the SSG with Initial Information.

A determination by the SSG that a given RMBS or CMBS CUSIP is eligible for financial modeling after an Initial Sufficiency Filing assessment is subject to the further and continuing obligation that the SSG obtain or the insurer provide the SSG with updated Ongoing Information close to the date of the annual surveillance.

**Required Documents for Initial Sufficiency Filing** – An insurer that owns an RMBS or a CMBS for which Initial Information is not publicly available shall provide the SSG with the following documentation.

1. **RMBS**

   Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for an RMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:

   - Pooling and Servicing Agreement or similar
   - Prospectus, Offering Memorandum or similar; Accountant’s comfort letter
   - If applicable, ISDA Schedules and Confirmations or similar
   - Legal opinions given in connection with the transaction
   - Any other documents referenced by the above
   - Third-Party Due diligence scope document and raw results.
   - If less than 100% due diligence, detailed description of the loan selection process.
   - If applicable, loan purchase agreements or similar.
   - Loan Tape
2. **CMBS**

   Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for a CMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:

   - Pooling and Servicing Agreement or similar
   - Prospectus, Offering Memorandum or similar; Accountant’s comfort letter
   - If applicable, ISDA Schedules and Confirmations or similar
   - Legal opinion given in connection with the transaction
   - Any other documents reference in the above
   - Asset Summaries
   - Loan Tape
     - Including reliable information about the terms of the transaction, including, but not limited to, financial covenants, events of default, legal remedies and other information about financial, contractual or legal aspects of the transaction in form and substance consistent with industry best practices for CMBS issuance.
   - In certain cases, additional documents below will enable the SSG to verify and validate initial underwriting information of the property securing the CMBS. These documents may be required in form and substance consistent with best practices for typical CMBS issuance.
     - Historical operating statements and borrower’s budget
     - Underwriter’s analysis of stabilized cash flow with footnotes of assumptions used
     - Property type specific, rent roll information
     - Appraisals and other data from recognized industry market sources
     - Independent engineering report (Property Condition Assessment)
     - Environmental Site Assessment (ESA) – Phase I/Phase II
     - Documentation related to seismic, flood and windstorm risks
     - Franchise agreements and ground leases, if applicable
     - Management agreements.

3. **SSG Modeling Alerts**

   The SSG shall at all times have discretion to determine that differences in the structure, governing law, waterfall structure or any other aspect of a securitization or a class of securitization requires that insurance companies provide Initial Information and or Ongoing Information additional to or different from that identified in this Part Seven. The SSG shall communicate such additional or different documentation requirements to insurers by publishing a Modeling Alert on the NAIC website and scheduling a meeting of the Valuation of Securities (E) Task Force to ensure public dissemination of the decision.

**B. Safe Harbor**

   Safe Harbor options serve as proxies for the Initial Sufficiency filing. The options reflect publicly available information that a third party has analyzed the Initial Information. Because the structured securities market is quite dynamic, the list of Safe Harbor options may change frequently, with notice and opportunity for comment, as described in Part One, Section 6 of this Manual. An RMBS or CMBS meets the Initial Information requirement if:
i. At least two Section 17(g)-7 reports issued by different CRPs are publicly available; or

ii. A security that is publicly registered under the Federal Securities Act of 1933.

(iii) Ongoing Information Requirements
An RMBS or CMBS meets the Ongoing Information Requirements if Ongoing Information is available to the SSG and the relevant third-party vendor from an Original Source. The SSG, in its sole discretion and in consultation with the relevant third-party vendor, may determine that the Ongoing Information is not sufficient or reliable to permit a given RMBS or CMBS CUSIP to be financially modeled. However, in making such a determination, the SSG shall take into account reasonable market practices and standards.

(iv) Special Rules for Certain Re-REMICs
Re-REMICs are generally simple restructurings of RMBS or CMBS. An Initial Sufficiency Filing for a Re-REMIC (a) which is not a Legacy Security itself but (b) where each Underlying Security is a Legacy Security shall not require submission of information regarding the Underlying Securities. In most cases, a prospectus for the Re-REMIC will be sufficient. If the SSG determines that additional information about the Re-REMIC structure or formation is required, it will communicate this decision to the insurer and invite a dialogue to ascertain whether additional information is available that would be deemed sufficient by the SSG.

Section 6 Analytical Assignments

a) Annual Surveillance of RMBS and CMBS – Modeled and Non-Modeled Securities - General Instructions

(i) Scope
This Section 6 (a) explains the financial modeling methodology applicable to RMBS and CMBS (defined in Section 2 of this Part above) securitizations and the carrying value methodology applicable to modeled and non-modeled securities subject to Statement of Statutory Accounting Principles No. 43 Revised – Loan-Backed and Structured Securities (SSAP No. 43R). Please refer to SSAP No. 43R for a description of securities subject to its provisions. The VOSTF Valuation of Securities (E) Task Force does not formulate policy or administrative procedures for statutory accounting guidance. Reporting insurance companies are responsible for determining whether a security is subject to SSAP No. 43R and applying the appropriate guidance.

(ii) Important Limitation on the Definitions of RMBS and CMBS
The definitions of RMBS and CMBS in Section 2 of this Part above are intended solely to permit the SVOSSG to communicate with financial modeling vendors, insurance company investors who own RMBS and CMBS subject to financial modeling and/or carrying value methodology and their investment advisors to facilitate the performance by the SVOSSG of the financial modeling methodology described below. The definitions contained in this Section are not intended for use and should not be used as accounting or statutory statement reporting instructions or guidance. Readers must refer to SSAP No. 43R for applicable accounting guidance and reporting instructions.
(iii) **Analytical Procedures Applicable to RMBS and CMBS Securitizations Subject to Financial Modeling Methodology**

1. **Filing Exemption Status of RMBS and CMBS**
   RMBS and CMBS are not eligible for the filing exemption provided in Part Two, Section 4 (d) (i) of this Manual because credit ratings of CRPs are no longer used to set risk-based capital (RBC) for RMBS or CMBS. However, RMBS and CMBS are not submitted to the SVO SSG. Please refer to Section 4 (c) (i) of this Part and Part Three, Section 3 (a) of this Manual for related instructions.

2. **Use of Financial Modeling for Year-End Reporting for RMBS and CMBS**
   Beginning with year-end 2009 for RMBS and 2010 for CMBS, probability weighted net present values will be produced under NAIC staff SVO supervision by an NAIC-selected vendor using its financial model with defined analytical inputs selected by the SVO SSG and approved by the VOS/TF. The vendor will provide the SVO SSG with a range of net present values for each RMBS or CMBS corresponding to each NAIC designation category. The NAIC designation for a specific RMBS or CMBS is determined by the insurance company, based on carrying value ranges. Please refer to SSAP No. 43R for guidance on all accounting and related reporting issues.

3. **Analytical Procedures for RMBS and CMBS**
   The SVO SSG shall develop and implement all necessary processes to coordinate the engagement by the NAIC of a vendor who will perform loan-level analysis of insurer-owned RMBS and CMBS using the vendor’s proprietary models.

   a. **RMBS and CMBS Subject to Financial Modeling**
      (i) **Setting Microeconomic Assumptions and Stress Scenarios**
      Not later than September of each year, the SVO SSG shall begin working with the vendor to identify the assumptions, stress scenarios and probabilities (hereafter model criteria) the SVO SSG proposes to use at year-end to run the vendor’s financial model.

      The VOS/TF shall schedule a regulator-to-regulator meeting so that it can consult with staff and the vendor on the proposed model criteria. The purpose of the regulator-to-regulator meeting is to permit the staff and vendor to explain its recommendations and how the analytical processes intended to be used will produce net present values of RMBS and CMBS, and as well as to permit the VOS/TF to provide policy direction that would assist the SVO SSG in identifying the technical approaches most likely to secure the regulatory objective. The SVO SSG shall incorporate whatever guidance is provided by the VOS/TF at this regulator-to-regulator meeting into the proposed model criteria and prepare a Proposed Model Criteria Document.

      If directed by the VOS/TF, the SVO SSG shall release the Proposed Model Criteria Document to the public in anticipation of a public meeting of the VOS/TF. The purpose of the public meeting is to provide an opportunity for insurance company investment managers with responsibility for RMBS and
CMBS to ask questions and comment on the proposed model criteria or process.

The SVOSSG is directed to consider the technical comments made by the industry and/or other interested persons during the public meeting. Subsequent to the meeting, the SVO shall prepare a questions-and-answers document in which it shall list and reply to the technical questions and concerns expressed at the public meeting. The SVOSSG may make whatever technical adjustments to the proposed model criteria it shall in its analytical discretion deem appropriate and publish a Final Proposed Model Criteria Document on its Web page.

(ii) The Financial Modeling Process

The SVOSSG shall obtain loan-level analysis of RMBS and CMBS using the selected vendor’s proprietary financial model.

The financial model used by the SVOSSG is expected to provide for each of the analytical steps that follow: a macroeconomic process, a mortgage loan credit process and a waterfall process.

The macroeconomic process projects the future performance of macroeconomic variables. These variables and various scenarios to be employed in this step of the financial modeling process will have been determined through the meetings described in subparagraph (i) above.

The mortgage loan credit process projects loan performance based on the projected macroeconomic variables and loan characteristics. The loan characteristics employed may be broadly identified and discussed in the Final Model Criteria Document to the extent the Valuation of Securities (E) Task Force deems it necessary to ensure attainment of regulatory objectives, but subject to legitimate commercial and proprietary interests of the financial model vendor.

The results of the mortgage loan credit model provide the scenario inputs to produce a tranche level cash flow “waterfall.”

What follows is, therefore, intended as a general description of one such process.

**LOAN-LEVEL ANALYSIS**

**RMBS** – Loan-level analysis begins with historical loan performance. Loans are classified as performing or non-performing. Based on loan characteristics and macroeconomic variables, transition probabilities are calculated. Because the parameters of the model are path-dependent, Monte Carlo simulation is used. A random drawing against these calculated probabilities decides the performance group or exit group (prepayment or default) that the loan will be assigned to during the next month. The loan-level prediction is then aggregated into pool level projected curve. For purposes of loss severity, the same default probabilities are applied to maintain consistency. Additional components that contribute to the ultimate loss severity analysis include collateral deficiency (unpaid balance less REO sales price), lost interest (accrued as servicer advances), expenses (legal fees, property taxes and brokerage fees) and mortgage insurance considerations.
CMBS – The vendor will review raw loan level data sourced from servicers and trustees for inconsistencies and inaccuracies, correcting the data where applicable. Based upon SVOSSG directions, the vendor will manually review and re-underwrite certain loans in each pool based upon size, credit history or other criteria at the discretion of the SVOSSG. In addition to loan level performance, the vendor’s analysis will reasonably take into account other factors known to bear on long-term property performance, such as age, size and locational characteristics. The vendor will then utilize market-derived income growth curves and capitalization rates to project the collateral performance of each loan in a given CMBS issue. Based on parameters and triggers such as debt service coverage levels, extension parameters and workout periods and costs, produce an outcome and loss estimate for each loan in the pool.

RMBS and CMBS

Once generated, pool cash flows are passed through the bond waterfall. The “waterfall” is a set of rules derived from the terms of the contract governing the RMBS or CMBS securitization that determine which bonds get paid principal and interest and how losses are distributed at a particular point in time. Waterfall models for individual RMBS and CMBS securitizations can be obtained from a reputable vendor (often referred to as a deal library).

The net present value for the insurer-owned RMBS or CMBS tranche is derived by applying a discount rate to the projected/probability weighted cash flow. In multiple scenario approaches, the mortgage credit model and waterfall model are used to calculate the present value of losses under each scenario.

The final valuation is the par value minus the probability weighted present value of losses. The interest rate used to discount the bond cash flow will be the bond coupon.

(iii) Validation of Modeled Results
The NAIC and SVOSSG staff shall ensure that the vendor has extensive internal quality-control processes in place. In addition, however, the SVOSSG shall conduct its own quality-control checks of the vendor’s valuation process.

(iv) Publication of Final Results
Upon delivery by the vendor of values for the RMBS and CMBS portfolio and subject to the final modeling process and completion of all SVOSSG quality control and validation processes, the SVOSSG shall cause the valuation file for the modeled insurer-owned portfolio to be delivered to other appropriate NAIC staff for dissemination to insurance companies.

(v) Use of Net Present Value and Carrying Value for Financially Modeled RMBS and CMBS
For each modeled RMBS and CMBS, the financial model determines the net present value at which the expected loss equals the midpoint between the RBC charges for each NAIC designation; i.e., each price point, if exceeded, changes the NAIC designation. Net present value is the net present value of principal losses, discounted using the security’s coupon rate (adjusted in case of original issue discount securities to book yield at original issue and in case of floating rate securities, discounted using LIBOR curve + Origination spread). Because of the difference in RBC charge, the deliverable is five values for each RMBS and CMBS security for companies required to maintain an asset valuation reserve (AVR) and
The NAIC designation for a given modeled RMBS or CMBS CUSIP owned by a given insurance company depends on the insurer’s carrying value of each RMBS or CMBS, whether that carrying value, in accordance with SSAP No. 43R, paragraphs 25–26a, is the amortized cost or fair value, and where the carrying value matches the price ranges provided in the model output for each NAIC designation; except that an RMBS or CMBS tranche that has no expected loss under any of the selected modeling scenarios and that would be equivalent to an NAIC 1 Designation if the filing exempt process were used, would be assigned an NAIC 1 Designation regardless of the insurer’s carrying value. Please refer to the detailed instructions provided in SSAP No. 43R.

Table One

| NAIC Designation Breakpoints for Loan Backed and Structured Securities |
|-----------|---|---|---|---|---|
| Life      | 1>2 | 2>3 | 3>4 | 4>5 | 5>6 |
| NAIC2     | 97.88 | 100.00 | 104.69 | 116.23 | 132.04 |
| NAIC3     | 93.49 | 95.52 | 100.00 | 111.02 | 126.12 |
| NAIC4     | 84.22 | 86.04 | 90.08 | 100.00 | 113.61 |
| NAIC5     | 74.13 | 75.73 | 79.29 | 88.02 | 100.00 |

<table>
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<th>2&gt;3</th>
<th>3&gt;4</th>
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<td>82.69</td>
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</table>

Designation changes when carrying value exceeds the breakpoint
subsequent filing with the SVO, or (Y) assigned the NAIC designation for Special Reporting Instruction; i.e., an
NAIC 5* or NAIC 6* (five-star or six-star), as discussed in Part Two, Section 5 of this Manual.

(C) Exclusion of Certain Securities from Application of Carrying Value Methodology for Non Modeled
Securities
(1) Exclusion and Excluded Securities
The carrying value methodology described in subsection (iv) A, above, shall not apply (the Exclusion) to Credit
Tenant Loans, Equipment Trust Certificates (whether rated by an NAIC CRP or designated for quality by the SVO)
or to every other individual security to which the SVO has assigned an NAIC Designation, (collectively, “Excluded
Securities”), effective with the 2011 year-end reporting cycle. Please refer to SSAP No. 43R, paragraph 26c.

(2) Deriving NAIC Designations for Excluded Securities
The NAIC Designation for Excluded Securities that are Credit Tenant Loans or Equipment Trust Certificates shall
be the credit rating assigned by CRPs after application of the filing exemption procedure described in Part Two,
Section 4 (d) (i) of this Manual or the NAIC Designation assigned by the SVO. The NAIC Designation for Excluded
Securities that are individual securities to which the SVO has assigned an NAIC Designation, shall be the NAIC
Designation assigned by the SVO. Please refer to SSAP No. 43R, paragraph 26c.

b) Mortgage Referenced Security
(A) Definition
Mortgage Referenced Security is a category of a Structured Note, as defined above in Part Three, Section 3 (b) (vi) of this Manual.

In addition to the Structured Note definition, the following are characteristics of a Mortgage Referenced Security:

A Mortgage Referenced Security’s coupon and/or principal payments are linked, in whole or in part, to prices of, or payment streams from, real estate, index or indices related to real estate, or assets deriving their value from instruments related to real estate, including, but not limited to, mortgage loans.

(B) Not Filing Exempt
A Mortgage Referenced Security is not eligible for the filing exemption in Part Two, Section 4 (c) (ii) or the filing exemption in Section 4 (d) of this Manual, but is subject to the filing requirement indicated in Part Two, Section 2 (a) of this Manual.

(C) NAIC Risk Assessment
In determining the NAIC designation of a Mortgage Referenced Security, the SSG may use the financial modeling methodology discussed in this Part Seven, Section 6(a), adjusted to the specific reporting and accounting requirements applicable to Mortgage Referenced Securities.

c) The RTAS – Emerging Investment Vehicle
(a) Purpose
Price grids are generated for the exclusive use of insurance companies and the NAIC regulatory community. Insurance companies use official Prices Grids by following the instructions in SSAP No. 43R, Loan Backed and Structured Securities, to derive a final NAIC Designation for the RMBS or CMBS, which they use to derive the RBC
applicable for the RMBS or CMBS. Please refer to SSAP No. 43R for a full explanation of the applicable procedure.

(b) Extension of Authority
The procedure specified in Part Four, Section 3 (a) of this Manual for the SVO is extended to the SSG, and the SSG is authorized to determine probable regulatory treatment for RMBS and CMBS pursuant to Section 5 (a) of this Part Seven or for other securities, where, in the opinion of the SSG, financial modeling methodology would yield the necessary analytical insight to determine probable regulatory treatment or otherwise enable the SSG to make recommendations to the VOS/TF as to regulatory treatment for a security, as discussed in Part Four, Section 3 (a) (ii) of this Manual.

(c) Interpretation
To facilitate this purpose, wherever in Part Four, Section 3 (a) (ii) of this Manual, reference is made to the SVO, it shall be read to also refer to and apply to the SSG, adjusting for differences in the operational or methodological context.

Part Four, Section 3 (a) (ii) of this Manual shall also be read as authority for collaboration between SVO and SSG Staff functions so as to encompass RTAS assignments that require the use of SVO financial, corporate, municipal, legal, and structural analysis and related methodologies, as well as of financial modeling methodologies.

(d) Translation of Preliminary into Official Price Grids
Price Grids generated by the SSG pursuant to an RTAS under this Section 6 (c) of this Part are preliminary within the meaning of that term as used in Part Four, Section 3 (a) (ix) of this Manual and accordingly cannot be used for official NAIC regulatory purposes.

Preliminary NAIC Designations are translated into official NAIC Designations by the SVO when an insurance company purchases and files the security and the SVO conducts an official assessment. However, the Purposes and Procedures Manual does not require the filing of RMBS and CMBS subject to financial modeling methodology with the SSG. It is, therefore, necessary to specify a procedure for the translation of preliminary Price Grids into official Price Grids that can be used for NAIC regulatory purposes.

Preliminary Price Grids generated by the SSG become an official Price Grid within the meaning of this Section when an insurance company has purchased the security for which the Price Grid was generated and reported that security for quarterly reporting purposes using the SSG generated Price Grid.

A Price Grid for a security reported by an insurance company for quarterly reporting is effective until the SSG conducts the next annual surveillance pursuant to Section 6 (a) of this Part, at which the time the Price Grids generated by the SSG at year-end shall be the official Price Grid for that security.
MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force
    Members of the Valuation of Securities (E) Task Force

FROM: Robert Carcano, Senior Counsel, NAIC Investment Analysis Office
       Harry Olsen, Manager II, NAIC Securities Valuation Office Credit Assessment/Valuation Group
       Robert Nelson, Senior Analyst, NAIC Securities Valuation Office Credit Assessment & Valuation Group

CC: Charles Therriault, Director, NAIC Securities Valuation Office

DATE: February 26, 2015

RE: Non-Recourse Loans

1. Introduction – The SVO was asked to discuss transactions called non-recourse notes and an SVO Senior Credit Committee decision to delete them from the VOS Database.

2. Structure – In a non-recourse note, an entity that derives its income from charitable contributions makes mortgage loans or business loans to persons who meet its charitable criteria. The entity then issues notes, either directly or through an intermediary, secured by the loan(s) it has made. Payment of interest and principal on the notes is made solely from the principal and interest paid by the loan recipient.

3. Methodology – Because the issuer has no legal responsibility to pay the notes, SVO methodologies, which require an assessment of the issuer’s audited financial statements, cannot be used to assess likelihood of payment. Quantification of the likelihood of payment or default requires financial modeling, which, in turn, requires reliable historical data about the loans. Such data is not available for charitable loans.

4. Population – To date, the SVO identified 51 non-recourse CUSIPs in the VOS Database (Attachment Two). Thirteen (11 issued by Community Preservation Corp.) were deleted during the 2014 annual review process. Thirty-eight CUSIPs (14 issued by Habitat for Humanity [HFH], 17 issued by Community Preservation Corp. and 7 issued by individual issuers) have been identified for deletion. A preliminary review of documentation indicates approximately 14 other transactions may not be non-recourse notes in that there is recourse to an issuer who can provide audited financial statements.

5. Statutory Accounting – The status of non-recourse notes under the NAIC statutory accounting framework is unclear. Non-recourse notes do not state an obligation to pay. The loans are made on the basis of charitable criteria, so their viability as a financial asset is questionable. The payment structure is not obligor-based and, therefore, does not fit the pattern of Statement of Statutory Accounting Principles (SSAP) No. 26—Bonds, Excluding Loan-Backed and Structured Securities. Pass-through of cash flow from loans suggest similarity to SSAP No. 43R—Loan-Backed and Structured Securities – Revised payment patterns, but a comparison of the structure to residential mortgage-backed securities (RMBS) (in the case of HFH notes) indicates the HHF CUSIPs would not be eligible for financial modeling as RMBS as defined by the NAIC. (HFH notes are secured by the general obligation of HFH affiliates, backed by 0% mortgages on low-income housing. Non-performing loans are replaced with “surplus notes,” with a limited recourse of 5% to HFH. (See Attachment One for a schematic of the structure.)

6. Conclusion – Non-recourse notes cannot be assessed for credit quality by SVO or Structured Securities Group (SSG) methodologies and do not appear to meet SSAP No. 4—Assets and Nonadmitted Assets, SSAP No. 26 or SSAP No. 43R.
criteria. To the extent they can be characterized as an investment, non-recourse notes most resemble a residual interest in a project of a charitable organization.

**Exhibit A – Structure of Loan**

- **Affiliate Loans in aggregate = Flexcap Loan**

- **Homeowner Loans = 125% Affiliate Loans**

- **Affiliates can only pledge a portion of loan portfolio. Obligated to use surplus loans to replace non-performing pledged loans**
## Attachment Two - Non-Recourse Transactions in VOS Database

<table>
<thead>
<tr>
<th>Name</th>
<th>CUSIP</th>
<th>ATF Deleted?</th>
<th>Deleted From VOS?</th>
<th>Why not designate?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asian American Drug Abuse Program</td>
<td>045168AA</td>
<td>Yes</td>
<td>No</td>
<td>Submitted ATF only no audit</td>
</tr>
<tr>
<td>Community Preservation Corp.</td>
<td>20401@AG6</td>
<td>Yes</td>
<td>Yes</td>
<td>Non-Recourse to Issuer</td>
</tr>
<tr>
<td></td>
<td>20401@AH4</td>
<td>Yes</td>
<td>Yes</td>
<td>Repayment comes solely from underlying</td>
</tr>
<tr>
<td></td>
<td>20401@AO7</td>
<td>Yes</td>
<td>Yes</td>
<td>real estate loan or loans.</td>
</tr>
<tr>
<td></td>
<td>20401@AR2</td>
<td>Yes</td>
<td>Yes</td>
<td>No audited information available</td>
</tr>
<tr>
<td></td>
<td>20401@ASO</td>
<td>Yes</td>
<td>Yes</td>
<td>on underlying loans for each CUSIP.</td>
</tr>
<tr>
<td></td>
<td>20401@AT8</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@AVS</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@AW1</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@AY7</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@AZ4</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@BD2</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@BCS</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@BF7</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@BG5</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@BH3</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@BR6</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@BL4</td>
<td>Yes</td>
<td>No</td>
<td></td>
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<tr>
<td></td>
<td>20401@AK7</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@AS5</td>
<td>Yes</td>
<td>No</td>
<td></td>
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<tr>
<td></td>
<td>20401@AV9</td>
<td>Yes</td>
<td>No</td>
<td></td>
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<tr>
<td></td>
<td>20401@AB8</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@BC4</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@BJO</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20401@B9J</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>CRF-18 LLC</td>
<td>12625IHM6</td>
<td>Yes</td>
<td>Yes</td>
<td>Same as below, was 6* in 2013 w/missed Pmt</td>
</tr>
<tr>
<td>FINCA Microfinance Fund BV</td>
<td>N2323RAA3</td>
<td>Yes</td>
<td>Yes</td>
<td>Repayment comes from underlying</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>performance on loans to finance entities</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>No audited information available</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>on underlying loans for each CUSIP.</td>
</tr>
<tr>
<td>Habitat for Humanity</td>
<td>40498@BG5</td>
<td>Yes</td>
<td>No</td>
<td>Initial Filing:</td>
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<tr>
<td></td>
<td>40499@BC6</td>
<td>Yes</td>
<td>No</td>
<td>Non-recourse notes secured by the GO notes</td>
</tr>
<tr>
<td></td>
<td>40499@B11</td>
<td>Yes</td>
<td>No</td>
<td>of Habitat Affiliates which are in turn</td>
</tr>
<tr>
<td></td>
<td>40499@BM6</td>
<td>Yes</td>
<td>No</td>
<td>secured by 0% mortgages on low income</td>
</tr>
<tr>
<td></td>
<td>40499@BM4</td>
<td>Yes</td>
<td>No</td>
<td>homes constructed by affiliates</td>
</tr>
<tr>
<td></td>
<td>40499@BE2</td>
<td>Yes</td>
<td>No</td>
<td>Audited data on Affiliates is not available</td>
</tr>
<tr>
<td></td>
<td>40499@BF9</td>
<td>Yes</td>
<td>No</td>
<td>Full recourse to the Affiliate</td>
</tr>
<tr>
<td></td>
<td>40499@B8K</td>
<td>Yes</td>
<td>No</td>
<td>5% recourse to Habitat National</td>
</tr>
<tr>
<td></td>
<td>40499@BN2</td>
<td>Yes</td>
<td>No</td>
<td>Underlying mortgages can’t be modeled</td>
</tr>
<tr>
<td></td>
<td>40499@B7P</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>40499@BAD</td>
<td>NA</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>40499@BBB</td>
<td>NA</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>40499@BGT</td>
<td>NA</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>40499@BHS</td>
<td>NA</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Impact Childcare LLC</td>
<td>45279AA</td>
<td>Yes</td>
<td>No</td>
<td>Non recourse, Pmt based on underlying loan</td>
</tr>
<tr>
<td>Impact Healthcare II LLC</td>
<td>45279AA</td>
<td>Yes</td>
<td>No</td>
<td>performance</td>
</tr>
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<td>Impact Healthcare III LLC</td>
<td>45256@AA2</td>
<td>Yes</td>
<td>No</td>
<td>Same as above</td>
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<tr>
<td>Low Income Fund</td>
<td>54750@AC</td>
<td>Yes</td>
<td>No</td>
<td>No audited financials submitted in 2014</td>
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<tr>
<td>National Trust for Historic Preservation</td>
<td>68320AA</td>
<td>Yes</td>
<td>No</td>
<td>No audited financials submitted in 2014</td>
</tr>
<tr>
<td>OPARC</td>
<td>68347AA</td>
<td>Yes</td>
<td>No</td>
<td>No audited financials submitted in 2014</td>
</tr>
</tbody>
</table>

---

**Issuers Not Yet Reviewed for Compliance**

- Ways to Work, Inc. 94675@AA
- MBS Parent LLC 57888@AA
- NJ Community Cap Fund #1 LLC 64577@AB
- Cororation for Supportive Housing 22006@AC
- Foundation for Senior Living 35039@EJ
- CHP New Market Investment Fund LLC 12548@AB
- Community Loan Fund NJ Inc 20373@AG
- Community Reinvestment Fund Inc 204028@E
- Reinvestment Fund Inc 79936@AA
- NHP Foundation 62925@AA
- SEEDCO Financial Services 81572@AA
- Nonprofit Fund Inc. 45537@AB
- Community Reinvestment Fund Inc 204028@F
- NCBDC Investment Fund 24 LLC 62881@AA

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MEMORANDUM

TO:   Stewart Guerin, Chair, Valuation of Securities (E) Task Force
      Members of the Valuation of Securities (E) Task Force

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office

CC:    Charles Therriault, Director, NAIC Securities Valuation Office

DATE: February 27, 2015

RE:     Staff Report – Announcing Change in the Publication Schedule of the Purposes and Procedures Manual of the NAIC Investment Analysis Office

1. Staff Report – The NAIC Publications Department recently announced that the Purposes and Procedures Manual will be made available for immediate download to AVS+ subscribers. Non-subscribers can purchase the Purposes and Procedures Manual from the NAIC store. To use the resources of the Investment Analysis Office more efficiently, the decision was made to publish the Purposes and Procedures Manual annually and to distribute adopted interim changes through the NAIC website on the SVO page. We expect to implement the new Web page process on or around April 30, 2015.

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MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force
FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office
CC: Charles Therriault, NAIC Director, Securities Valuation Office
Eric Kolchinsky, NAIC Director, Structured Securities Group
Edward Toy, NAIC Director, Capital Markets Bureau
Todd Sells, NAIC Director, Financial Regulatory Services
DATE: October 2, 2014
RE: Referral from the Financial Condition (E) Committee Requesting a Review of the NAIC Derivative Instruments Model Regulation

1. Introduction – The Financial Condition (E) Committee has requested that the Task Force review the Derivatives Instruments Model Regulation (#282) (“Model #282”) and opine whether it should be retained as a model law, amended, converted to a guideline or archived. The request was referred to the Financial Condition (E) Committee by the Executive (EX) Committee, which is conducting a Model Law Review Initiative1 under the NAIC’s Procedures for Model Law Development (“Procedures”). The Procedures require NAIC members to affirmatively support adopted NAIC model laws.2 To identify those adopted models that NAIC members may no longer want to support, the Procedures3 provide for a review of the rates of adoption and an assessment whether the rates imply a consensus that the subject of the model requires a minimum national standard or uniformity among the states and a commitment by NAIC members to devote the resources necessary to support the model (the “Review”).4

2. A Threshold Issue – Since its most recent revision and re-adoption by the NAIC in 2009, one state has adopted Model #282. Nine other states have adopted some other related legislation, which could be an older version of the NAIC model or

---

1 In support of the Review, the NAIC Legal Division performs a preliminary review to identify model laws that should be reviewed in the coming year. The model laws are selected because they were: 1) adopted and/or amended after the 2007 Model Law criteria became effective; 2) not associated with an accreditation standard; and 3) not associated with a federal law directive.

2 Implementation of the Model Law “Upon NAIC adoption of the Model Law, it will be a priority of the NAIC, through the collective efforts of the Members, to uniformly adopt the Model Law in a majority of states within three years after its adoption by the NAIC membership. The NAIC Members will devote significant regulator and NAIC resources to communicate, educate and support the Model Law. The NAIC staff will provide briefing materials, testimony, make state visits and answer questions. The Executive Committee shall provide updates to the NAIC Plenary on the status of adoption by states of the Model Law.” From Procedures for Model Law Development, adopted May 2007 and amended September 2008 and July 2013.

3 Review of Existing Model Laws The Executive (EX) Committee may undertake a review of the adoption rates of existing Model Laws. If the Executive (EX) Committee determines the existing Model Law does not meet the criteria, it shall be reclassified as a Guideline as defined above. If the Executive (EX) Committee determines the existing Model Law meets the criteria, it will be made a priority of the NAIC to pursue uniform adoption in the remaining states.

4 Model Law Development Criteria. The Executive (EX) Committee of the NAIC, upon a recommendation of the Parent Committee, will determine if a proposed new Model Law (or Regulation) or amendment to an existing Model Law (or Regulation) meets a two-pronged test (Model Law Development Criteria) as follows: 1) the issue that is the subject of the Model Law necessitates a minimum national standard and/or requires uniformity amongst all states; and 2) where NAIC Members are committed to devoting significant regulator and association resources to educate, communicate and support a model that has been adopted by the membership. From Procedures for Model Law Development, adopted May 2007 and amended September 2008 and July 2013.
legislation or regulation derived from other sources. The threshold issue before the Task Force is whether the Review is intended to be a mechanistic assessment of rates. If so, the above information would indicate that NAIC members do not see a need for a national or a uniform derivatives standard and are not willing to support Model #282. However, a referral to the Task Force would not have been necessary if the Procedures contemplated that the Review would be a purely mechanical assessment as such an assessment could have been performed by NAIC staff.

3. Background - The Task Force conducted a review of Model #282 beginning in 2006 before the Procedures had been adopted. It completed the review in 2007 as the Procedures were being phased in and implemented changes to NAIC guidance in 2009, after the Procedures had been adopted. In 2005 and 2006, the Task Force noted that although the rate of adoption of Model #282 itself was low (four states), 19 states had adopted one or both of the derivatives section of the Investments of Insurers Model Act (Defined Limits Version) (Model #280) of which Model #282 was companion legislation. More importantly, the Task Force focused on the nature of the derivatives industry and instruments and concluded that the subject matter required a national standard irrespective of state rates of adoption. Accordingly, the Task Force formed the Derivative Market Study (E) Working Group and charged it with conducting a study of changes in the derivatives market and of insurer’s use of derivatives. The study led to a significant streamlining and revision of the reporting schedules to obtain more meaningful information about insurer derivative activity. It also led to referrals to other NAIC groups to modify other regulatory guidance for derivatives, which resulted in revisions to Model #282 and a recommendation that the NAIC retain it as a national standard.

4. Recommendation – The financial landscape has been significantly altered since the Task Force concluded its review of Model #282 in 2007. The SVO and Structured Securities Group (SSG) recommend that the Task Force undertake an evaluation of changes in federal laws and regulation governing derivatives, current insurer uses of derivatives and changes in the derivatives marketplace. This evaluation could be implemented in a series of public meetings supported by staff research and staffed by legal and derivatives industry experts, federal regulators and insurance company investment professionals supporting and knowledgeable about insurer derivatives activity. The result of staff research and the information gathered at the meetings could then be used to evaluate whether changes are needed to existing NAIC guidance on derivatives, including, but not limited to, statutory accounting and reporting instructions. In turn, these considerations would provide a holistic perspective from which the Task Force could determine how best to respond to the Financial Condition (E) Committee.

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5 The 2013 Model Review Criteria Worksheet for Model #282 created by the NAIC Legal Department indicates one state adopted the 2009 version. The new as part of the current Review. The Model Regulation Service as of April 2012 identifies the states that have the same or related activity. Please see Attachment Eight-A.

6 To: Jeffrey C. Johnston, Director, Financial Regulatory Services – NAIC; Todd Sells, Senior Financial Regulatory Services Manager - NAIC, Leslie Geel, Financial Research Manager
From: Michael Moriarty, Chair of the Valuation of Securities Task Force; Bob Carcano, Senior Counsel, SVO - NAIC
Re: Model Regulation 282 — Derivatives Model Law — Referral from NAIC Staff
Date: November 18, 2005

"... The senior staff has asked the Task Force to review the staff recommendation and to provide any comments and/or revisions the Task Force deemed appropriate. The Task Force considered the staff recommendation and discussed it in two interim meeting conference calls held on August 18 and October 4. It is the sense of the Task Force that it would be inappropriate to delete Model Regulation 282 without first assessing whether developments in the derivatives marketplace require changes in regulation. However, a study of developments in the derivatives market would require a significant commitment of time and resources. Accordingly, the Task Force has agreed to direct a study of the derivatives marketplace as a 2006 project and has instructed the SVO to research current regulation and to provide feedback to the Task Force early next year. During the discussions held on Model Regulation 282, interested persons questioned whether enough states had adopted the Model Regulation to warrant the dedication of time and resources that a thorough review of the derivatives markets would require. While the SVO found that only four states (CA, CT, IL and NY) have adopted Model Regulation 282, 19 states have adopted one or both of the derivatives section of the Investment of Insurers Model Act (Defined Limits Version). We concluded that this was a better indicator of regulatory interest in an updated understanding of the derivatives marketplace.” NAIC Proceedings 2005 4th Qtr at page 2065, 2128 - Attachment Fourteen, Valuation of Securities (E) Task Force meeting of 12/4/05.

The activity of the Task Force and of the Working Group are documented in the following NAIC Proceedings:
2005 – 2nd Quarter (Q); 3rd Qtr at page 543; 4th Qtr at page 2065
2006 – 3rd Qtr at page 1581; 4th Qtr at page 1902
2007 - 1st Qtr at page 1243; 2nd Qtr at page 1045; 3rd Qtr at page 1323; 4th Qtr at page 10-616
2008 - 2nd Qtr at page 10-625; 3rd Qtr at page 10-742; 4th Qtr at page 10-717
2009 - 1st Qtr at page 10-562.

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Section 6.  Documentation Requirements
Section 7.  Trading Requirements
Section 8.  Effective Date

Section 1.  Authority

This regulation is adopted and promulgated by the Commissioner of Insurance pursuant to [insert citation to state law equivalent to Section 8 of the Investments of Insurers Model Act].

Section 2.  Purpose

The purpose of this regulation is to set standards for the prudent use of derivative instruments in accordance with [insert citation to state law equivalent to Section 9 and 18 of the Investments of Insurers Model Act].

Section 3.  Definitions

For the purposes of this regulation, the following definitions shall apply:

A.  “Business entity” includes a sole proprietorship, corporation, limited liability company, association, partnership, joint stock company, joint venture, mutual fund, trust, joint tenancy or other similar form of business organization, whether for-profit or not-for-profit.

B.  “Counterparty exposure amount” means:

(1) The net amount of credit risk attributable to a derivative instrument entered into with a business entity other than through a qualified exchange, qualified foreign exchange, or cleared through a qualified clearinghouse (“over-the-counter derivative instrument”). The amount of credit risk equals:

(a) The market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurance company; or

(b) Zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurance company.

(2) If over-the-counter derivative instruments are entered into pursuant to a written master agreement which provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or if not within the United States, within a foreign jurisdiction listed in the Purposes and Procedures of the Securities
Valuation Office as eligible for netting, the net amount of credit risk shall be the greater of zero or the net sum of:

(a) The market value of the over-the-counter derivative instruments entered into pursuant to the agreement, the liquidation of which would result in a final cash payment to the insurance company; and

(b) The market value of the over-the-counter derivative instruments entered into pursuant to the agreement, the liquidation of which would result in a final cash payment by the insurance company to the business entity.

(3) For open transactions, market value shall be determined at the end of the most recent quarter of the insurance company’s fiscal year and shall be reduced by the market value of acceptable collateral held by the insurance company or placed in escrow by one or both parties.

C. (1) “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:

(a) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or

(b) That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

(2) Derivative instruments include options, warrants, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar thereto or any series or combination thereof. Derivative instruments shall additionally include any agreements, options or instruments permitted under regulations adopted pursuant to [insert citation to state law equivalent to Section 8 of the Investments of Insurers Model Act]. Derivative instruments shall not include an investment authorized by [insert state law equivalent to Sections 11 through 17, 19 and 24 through 30 of the Investments of Insurers Model Act].

D. “Qualified clearinghouse” means a clearinghouse for, and subject to the rules of a qualified exchange or a qualified foreign exchange, which clearinghouse provides clearing services, including acting as a counterparty to each of the parties to a transaction such that the parties no longer have credit risk as to each other.

E. “Qualified exchange” means:

(1) A securities exchange registered as a national securities exchange, or a securities market regulated under the Securities Exchange Act of 1934 (15 U.S.C. §§ 78 et seq.), as amended;

(2) A board of trade or commodities exchange designated as a contract market by the Commodity Futures Trading Commission or any successor thereof;
(3) Private Offerings, Resales and Trading through Automated Linkages (PORTAL);

(4) A designated offshore securities market as defined in Securities Exchange Commission Regulation S, 17 C.F.R. Part 230, as amended; or

(5) A qualified foreign exchange.

F. “Qualified foreign exchange” means a foreign exchange, board of trade or contract market located outside the United States, its territories or possessions:

(1) That has received regulatory comparability relief pursuant to Commodity Futures Trading Commission Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC’s Regulations, 17 C.F.R. Part 30);

(2) That is, or its members are, subject to the jurisdiction of a foreign futures authority that has received regulatory comparability relief pursuant to Commodity Futures Trading Commission Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC’s Regulations, 17 C.F.R. Part 30) as to futures transactions in the jurisdiction where the exchange, board of trade or contract market is located; or

(3) Upon which foreign stock index futures contracts are listed that are the subject of no-action relief issued by the CFTC’s Office of General Counsel, but an exchange, board of trade or contract market that qualifies as a “qualified foreign exchange” only under this paragraph shall only be a “qualified foreign exchange” as to foreign stock index futures contracts that are the subject of such no-action relief under this paragraph.

Section 4. Guidelines and Internal Control Procedures

A. Before engaging in a derivative transaction, an insurance company shall establish written guidelines, approved by the Commissioner, that shall be used for effecting and maintaining derivative transactions. The guidelines shall:

(1) Specify insurance company objectives for engaging in derivative transactions and derivative strategies and all applicable risk constraints, including credit risk limits;

(2) Establish counterparty exposure limits and credit quality standards

(3) Identify permissible derivative transactions and the relationship of those transactions to insurance company operations; for example, a precise identification of the risks being hedged by a derivative transaction; and

(4) Require compliance with internal control procedures.

B. An insurance company shall have a written methodology for determining whether a derivative instrument used for hedging has been effective.
C. An insurance company shall have written policies and procedures describing the credit risk management process and a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the counterparty exposure amount.

D. An insurance company's board of directors shall, in accordance with [insert citation to state law equivalent of Section 4 of the Investments of Insurers Model Act]:

   (1) Approve the written guidelines, methodology and policies and procedures required by Subsection A, B and C respectively, of this section and the systems required by Subsections B and C of this section; and

   (2) Determine whether the insurance company has adequate professional personnel, technical expertise and systems to implement investment practices involving derivatives.

   (3) Review whether derivatives transactions have been made in accordance with the approved guidelines and consistent with stated objectives.

   (4) Take action to correct any deficiencies in internal controls relative to derivative transactions.

Section 5. Commissioner Approval

Written documentation explaining the insurance company’s internal guidelines and controls governing derivative transactions shall be submitted for approval to the Commissioner. The Commissioner shall have the authority to disapprove the guidelines and controls proposed by the company if the insurance company cannot demonstrate the proposed internal guidelines and controls would be adequate to manage the risks associated with the derivative transactions the insurance company intends to engage in.

Section 6. Documentation Requirements

An insurance company shall maintain documentation and records relating to each derivative transaction, such as:

   A. The purpose or purposes of the transaction;

   B. The assets or liabilities to which the transaction relates;

   C. The specific derivative instrument used in the transaction;

   D. For over-the-counter derivative instrument transactions, the name of the counterparty and the market value; and

   E. For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade and the market value.
Section 7. Trading Requirements

Each derivative instrument shall be:

A. Traded on a qualified exchange;

B. Entered into with, or guaranteed by, a business entity;

C. Issued or written with the issuer of the underlying interest on which the derivative instrument is based; or

D. Entered into with a qualified foreign exchange.

Section 8. Effective Date

This regulation shall become effective [insert date].

Chronological Summary of Action (all references are to the Proceedings of the NAIC).

2009 Proc. 2nd Quarter (amended and reprinted).
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DERIVATIVE INSTRUMENTS MODEL REGULATION

These charts are intended to provide the readers with additional information to more easily access state statutes, regulations, bulletins or administrative rulings which are related to the NAIC model. Such guidance provides the reader with a starting point from which they may review how each state has addressed the model and the topic being covered. The NAIC Legal Division has reviewed each state's activity in this area and has made an interpretation of adoption or related state activity based on the definitions listed below. The NAIC's interpretation may or may not be shared by the individual states or by interested readers.

This state page does not constitute a formal legal opinion by the NAIC staff on the provisions of state law and should not be relied upon as such. Every effort has been made to provide correct and accurate summaries to assist the reader in targeting useful information. For further details, the laws cited should be consulted. The NAIC attempts to provide current information; however, due to the timing of our publication production, the information provided may not reflect the most up to date status. Therefore, readers should consult state law for additional adoptions and subsequent bill status.
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DERIVATIVE INSTRUMENTS MODEL REGULATION

KEY:

MODEL ADOPTION: States that have citations identified in this column adopted the most recent version of the NAIC model in a **substantially similar manner**. This requires states to adopt the model in its entirety but does allow for variations in style and format. States that have adopted portions of the current NAIC model will be included in this column with an explanatory note.

RELATED STATE ACTIVITY: States that have citations identified in this column have **not** adopted the most recent version of the NAIC model in a substantially similar manner. Examples of Related State Activity include but are not limited to: An older version of the NAIC model, legislation or regulation derived from other sources such as Bulletins and Administrative Rulings.

NO CURRENT ACTIVITY: No state activity on the topic as of the date of the most recent update. This includes states that have repealed legislation as well as states that have never adopted legislation.

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