VALUATION OF SECURITIES (E) TASK FORCE

Valuation of Securities (E) Task Force Aug. 4, 2019, Minutes
Valuation of Securities (E) Task Force May 10, 2019, Minutes (Attachment One)
Draft Pending Adoption

Date: 8/14/19

Valuation of Securities (E) Task Force
New York, NY
August 4, 2019

The Valuation of Securities (E) Task Force met in New York, NY, Aug. 4, 2019. The following Task Force members participated: Robert H. Muriel, Chair, represented by Kevin Fry (IL); James J. Donelon, Vice Chair, represented by Stewart Guerin (LA); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kathy Belfi (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmairer represented by Ray Spudeck and Carolyn Morgan (FL); Doug Ommer represented by Carrie Mears (IA); Vicki Schmidt represented by Tish Becker (KS); Gary Anderson represented by John Turchi (MA); Al Redmer Jr. represented by Vincent O’Grady (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Bruce R. Ramge represented by Lindsay Crawford and Justin Schrader (NE); Marlene Caride represented by John Sirovetz (NJ); Linda A. Lacewell represented by James Matheson and Jim Everett (NY); Glen Mulready represented by Eli Snowbarger (OK); Jessica Altman represented by Kimberly Rankin (PA); Kent Sullivan represented by Jamie Walker (TX); Todd E. Kiser represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Patrick McNaughton (WA); and Mark Afable represented by Randy Milquet (WI).

1. Adopted its May 30 and Spring National Meeting Minutes

Mr. Fry said the Task Force met May 30 and April 7. During its May 30 meeting, the Task Force took the following action: 1) received and discussed a referral from the Statutory Accounting Principles (E) Working Group on structured notes and receive a proposed Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) amendment to update the definition and instructions for structured notes; 2) heard a joint NAIC staff and industry report on the project to review existing credit tenant loan (CTL) guidance and possible new guidance on other lease-based transactions; 3) received and discussed a referral from the Statutory Accounting Principles (E) Working Group on regulatory transactions and received a proposed P&P Manual amendment to add instructions for new administrative fields “RTS” and “RT”; 4) discussed a referral to the Blanks (E) Working Group to add a NAIC designation related to the comprehensive fund instructions; 5) discussed a referral to the Capital Adequacy (E) Task Force on the comprehensive fund instructions; 6) received a proposed P&P Manual amendment to remove obsolete modified filing exempt (MFE) instructions; and 7) discussed a referral to the Blanks (E) Working Group on the NAIC designation modifier and NAIC designation category along with the “SVO” administrative symbol.

Ms. Belfi made a motion, seconded by Ms. Walker, to adopt the Task Force’s May 30 (Attachment One) and April 7 (see NAIC Proceedings – Spring 2019, Valuation of Securities (E) Task Force) minutes. The motion passed unanimously.

2. Adopted an Amendment to the P&P Manual to Update the Definition and Instructions for Structured Notes

Mr. Fry discussed a proposed amendment to the P&P Manual to update the definition and instructions for structured notes. This amendment was drafted after a referral from the Statutory Accounting Principles (E) Working Group requesting that the Task Force update its reporting and definition guidance for structured notes. A structured note is defined as an investment that is structured to resemble a debt instrument, where the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due. Structured notes reflect derivative instruments that are wrapped up within a debt structure.

Industry requested that NAIC staff reconcile the language between definition references in Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds and SSAP No. 86—Derivatives. Mr. Fry said that Attachment Three in the packages that were distributed prior to this meeting with the notation “Amended July 15, 2019” reflects this requested change along with a strike out to the 2018 manual, as the Task Force previously adopted the new manual format. Attachment Three-A is the originally exposed amendment, which was exposed for a 30-day comment period ending July 8.

Mr. Fry said the Task Force received two comment letters. The first was a joint comment letter from the American Council of Life Insurers (ACLI) and the North American Securities Valuation Association (NASVA) that requested the language alignment between the SSAP, which is reflected in Attachment Three. Mr. Fry asked if anyone from either group would like to comment. Mike Reese (Northwestern Mutual), representing the ACLI, said the proposed changes in the attachment address the ACLI’s concerns and it is happy with the changes.

Mr. Fry said a joint comment letter from Keith Bell (The Travelers Companies) and Rose Albrizio (AXA Equitable) was also received. He said it was addressed to the Statutory Accounting Principles (E) Working Group, but the Task Force was copied
on it. Mr. Fry asked if they would like to speak on their letter. Mr. Reese commented that the letter was attached as additional material to the ACLI letter.

Mr. Fry asked if the Working Group had made the revisions to SSAP No. 26R, No. 43R—Loan-Backed and Structured Securities and SSAP No. 86—Derivatives. Julie Gann (NAIC) explained that the revisions for structure notes and SSAP No. 26R, SSAP No. 43R, SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments and SSAP No. 86 to identify they were in scope were adopted at the Spring National Meeting. The item that is being discussed now at the Working Group is guidance for other derivatives in scope of SSAP No. 86. The guidance for structure notes is final.

Ms. Belfi made a motion, seconded by Mr. Schrader, to adopt the proposed amendment to the P&P Manual amendment, as amended on July 15 to delete the definition of structured notes and to make related modifications to the P&P Manual consistent with the changes adopted by the Statutory Accounting Principles (E) Working Group to SSAP No. 26R and SSAP No. 43R for these investments. The motion passed unanimously.

3. Further Revise and Re-expose Amendment to the P&P Manual to Add Instructions for new Administrative Fields “RTS” and “RT”

Mr. Fry discussed a referral from the Statutory Accounting Principles (E) Working Group requesting the Task Force add new reporting codes for investments that meet the definition of a regulatory transaction within the P&P Manual. Given the P&P Manual restrictions in reporting NAIC designations for regulatory transactions, the Working Group noted that there was no reporting mechanism to identify regulatory transactions or a Securities Valuation Office (SVO) analytical value for risk-based capital (RBC) assessment on the investment schedules.

The referral from the Working Group requested the Task Force to address reporting for regulatory transactions. The P&P Manual defines the term “regulatory transactions” and provides that a domiciliary state insurance department may request SVO or Structured Securities Group (SSG) assistance in the assessment of a regulatory transaction, with the understanding that the state can adopt the SVO or SSG work product as its own, but the determination is a state determination and not an NAIC work product. The Task Force agreed with the Working Group at its May 30 meeting that there was no specific instruction for reporting regulatory transactions and that reporting entities do not have any available reporting options when investment schedules require an NAIC designation. This amendment would add reporting codes for the investment component of regulatory transactions. Under this proposal, a reporting entity would use the code “RTS” when the domiciliary state has received assistance from the SVO or SSG in reviewing a regulatory transaction. In those cases, the code would be reported with the “analytical value” (a new term defined in the amendment) assigned by the SVO or SSG and given to the state. NAIC staff believe there may be some additional administrative symbol combinations that may be necessary, specifically “Z”, “IF” and “YE”, that could be handled in a separate non-substantive amendment to go along with any Blanks (E) Working Group referral. For all other regulatory transactions when the domiciliary state did not ask the SVO or SSG for assistance or those where the SVO or SSG was unable to determine an analytical value for the transaction for the state, the code “RT” would be used. This code would be reported with an NAIC 6 designation for measurement and RBC assessment. These codes would be specific to Schedule D, Part 1 reporting because those schedules require reporting an “NAIC designation” for all securities. A reporting entity may identify a regulatory transaction on other investment schedules, but such other schedules do not require that an NAIC designation be reported.

Mr. Fry said that two comment letters were received. The first letter was from the State of Vermont Department of Financial Regulation (DFR). The DFR noted that a “state regulator must explicitly approve the admittance of the investment security component of a Regulatory Transaction as a permitted or prescribed practice in order for an insurance company to report it as an admitted asset” and that “a state insurance department should be allowed to assess the credit quality of the security component and assign an analytical value, without the assistance of the SVO, during the review and approval of such regulatory transaction.” The DFR also proposed updates to the amendment. Mr. Fry asked if anyone from the Vermont DFR would like to comment on the letter.

Mr. Fry said that is not the Task Force’s practice—due to uniformity, accounting and the whole statutory framework—that an individual state could designate a security that would have regulatory meaning. If it went through the SVO, it would be accommodated in this proposal.

Mr. Fry said there was a second joint comment letter from the ACLI and NASVA. They are supportive of the intent to clarify requirements and reporting options for holdings determined to meet the definition of “regulatory transactions.” They suggested that additional clarity within and among the proposed amendments would be necessary to provide reporting entities a clear path for meeting the requirements and reporting standards envisioned by the Task Force. They proposed some editorial
Draft Pending Adoption

Modifications to reduce potential ambiguities regarding the process for transition and enforcement. Mr. Fry asked if the ACLI or NASVA would like to comment on their letter.

Josh Bean (Transamerica Capital Strategy), representing the ACLI and NASVA, said that they appreciate the Task Force’s attention to this important matter and the opportunity to comment further. He said they have forwarded a joint comment letter outlining three points that they thought merited additional discussion. He said they are fine with walking away with the suggestion regarding an additional administrative code, which was similar to what was proposed in Vermont’s comment letter. Mr. Bean said they appreciate the clarity that a potential additional amendment would achieve to help them work through transition periods and contesting the classification as a regulatory transaction. He said the one area that remains is that they do believe that some of the terminology is very important here as this is a somewhat complicated and confusing process for entities that are reporting entities. Mr. Bean said they would like to see some of the Task Force’s editorial clarification come through in the language to ultimately ensure that the guidance is unequivocally clear, comprehensible and actionable for the reporting entities. This relates to the security component of a regulatory transaction as opposed to the broader term regulatory transaction itself. He requested a little bit of additional time, either through friendly amendments or possibly a very short re-exposure period, where the Task Force can work through those issues with the SVO.

Mr. Fry explained that this is ready to go but that there is slight clean-up that needs to get done. Mr. Fry asked if the Task Force would like to move this now and then turn around and make some tweaks. He said they know that some administrative symbols still need to be added. Mr. Fry suggested having SVO staff work with the ACLI and industry to propose those clarifying amendments and needed administrative symbols to provide flexibility at year-end and pick this up during an interim call.

Ms. Belfi had a question on timing, as she said she would like to see this implemented sooner rather than later to provide clarity to both industry and state insurance regulators. Mr. Fry said he wants this in place for this year end and if the Task Force goes with a 15-day exposure period to tweak the language a little bit and add a few symbols, the Task Force may make it work better. Mr. Fry asked Charles A. Therriault (NAIC) to comment. Mr. Therriault said that if there is a short re-exposure, with some minor edits, with a September or early October interim meeting, then this amendment could be ready to adopt for this year-end.

Ms. Belfi made a motion, seconded by Ms. Mears, to direct SVO staff to work with industry on clarifying an administrative update to this amendment and then re-expose the amendment, after those revisions are made, for a two-week public comment period. The motion passed unanimously.

4. Received and Exposed a Proposed P&P Manual Amendment to Update the Definition and Instructions for PPNs

Mr. Fry discussed a proposed memorandum and amendment to the P&P Manual from the SVO staff on principal protected notes (PPNs). These are a type of structured note that do not meet the definition discussed in the second agenda item. It is an investment that is structured to resemble a debt instrument, where the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due. The contractual amount to be paid at maturity is not at risk for a PPN. However, not all of the financial risks associated with these securities are being reflected in the credit rating provider (CRP) rating being assigned to them. Mr. Fry said he asked the SVO to prepare this amendment and asked Mr. Therriault to review the memorandum and amendment for the Task Force.

Mr. Therriault said the SVO was seeing more of these structured note transactions come through its filings and raised its concerns to the Financial Regulatory Services (FRS) staff and chairs of this Task Force and the Statutory Accounting Principles (E) Working Group. The uncertain principal repayment version of structured notes has been addressed, but the obscured financial risk characteristics associated with PPNs has not. The memorandum highlighted two common structures for these investments, but there are many other possible variations. The first is the more “traditional” PPN, where there are two assets: 1) a zero-coupon U.S. Treasury bond; and 2) some other performance asset, such as a derivative contract or equity security. The zero-coupon U.S. Treasury, when it is purchased at a discount, will accrete up sufficiently to repay principal at maturity. The CRP rating focuses only on the risk of the zero-coupon U.S. Treasury and ignores the financial risks associated with the performance assets.

Mr. Therriault said that the second example is similar. However, he said the portfolio of the structure devoted towards principal repayment is a rated corporate bond—in this case, a BBB security. The structure pays a small interest payment to the investor, but it is only a small portion of the coupon being paid on the rated corporate bond. The interest difference between the coupon on the corporate bond and the interest paid to the PPN investor is used to accumulate a balance over the life of the transaction—30 years in this example, which is sufficient to repay the principal at maturity. Again, the CRP rating only focuses on the repayment of principal risk and ignores the financial risks of performance assets.

© 2019 National Association of Insurance Commissioners
Draft Pending Adoption

Mr. Therriault said he believes these structures obscure the overall financial risk of the investment to state insurance regulators because the CRP ratings focus on the repayment of principle, which fails to reflect the financial risk of the performance assets, which is also part of the structure. He said NAIC designation needs to reflect the overall risk of the investment, including the source and nature of the performance asset. Ignoring the overall financial risk artificially gives these investments a highly favorable NAIC designation under the filing exempt (FE) policy. He said that the CRPs are following their published methodology for these investments, but the SVO does not believe that methodology meets the NAIC’s needs. The SVO has existing methodologies to assess the overall risk associated with PPNs and recommends that they be removed from the FE process and have the SVO review them going forward.

Mr. Fry said what is being proposed is remove these from the FE process. They would still be able to be an asset on Schedule D if they are filed with the SVO and the SVO gives them a designation.

Ms. Walker made a motion, seconded by Mr. Fletcher, to receive the P&P Manual amendment to remove PPNs from being eligible for FE and expose it for a 45-day public comment period ending Sept. 20. The motion passed unanimously.

5. Received and Exposed a Proposed P&P Manual Amendment to Update the Interim Instructions for Mortgage Reference Securities

Mr. Fry discussed a proposed P&P Manual amendment to update the interim report instructions for mortgage reference securities. Mortgage reference securities are analyzed by the SSG each year-end. There are currently no instructions in the P&P Manual to assign an NAIC designation to newly issued or acquired mortgage reference securities. This amendment would add interim reporting instructions for mortgage reference securities. Mr. Fry said that the SSG models residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) now and the Task Force applies the breakpoints to that. These securities are kind of a special sub-class issued by Fannie Mae and Freddie Mac. He said that the SSG does not use the breakpoint methodology, but it does use the modeling process to determine their investment risk.

Mr. Garn made a motion, seconded by Mr. Sirovetz, to receive the P&P Manual amendment to add interim report instructions for mortgage reference securities and expose it for a 30-day public comment period ending Sept. 5. The motion passed unanimously.

6. Adopted a P&P Manual Amendment to Delete Stray Reference to MFE

Mr. Fry said that on Oct. 11, 2018, the Task Force adopted an amendment to delete the MFE provisions from the P&P Manual and directed a referral to the Statutory Accounting Principles (E) Working Group recommending the deletion of the MFE provisions from SSAP No. 43R. Representatives of the ACLI, NASVA and the Private Placement Investors Association (PPIA) identified a reference to MFE in Part Three, Section 1 (b) of the 2018 P&P Manual. This amendment would delete these obsolete MFE provisions from the P&P Manual. When the MFE process was deleted, there was one little piece of the P&P Manual that had a small reference to that process, and this amendment removes that reference.

Mr. Fry said that the Task Force received a joint comment letter from the ACLI and NASVA, and they are supportive of this proposed amendment. He asked if anyone from the ACLI or NASVA would like to comment on the letter. Mr. Bean said, as mentioned in their comment letter, the ACLI and NASVA fully support this proposal and appreciate the Task Force’s attention.

Ms. Mears made a motion, seconded by Mr. Schrader, to adopt this amendment to remove the outdated residual Modified Filing Exempt (MFE) text from P&P Manual. The motion passed unanimously.

7. Heard a Report on the Project to Review Existing CTL Guidance and Possible New Guidance on Other Lease-Based Transactions

Mr. Therriault said a meeting was held with the industry group on June 24 at the SVO’s offices. The industry group subsequently provided SVO staff with several example transaction legal agreements. The SVO has begun reviewing these materials provided but has still not formed an opinion or drafted a recommendation. He said that the SVO is in the process of hiring a new investment counsel and that this has delayed the review of these legal agreements. Mr. Therriault said he recommends that the Task Force issue instructions to insurers to continue reporting these other lease-based transactions as they have done in the past to avoid any disruptions for this year end. The SVO will continue working with the industry group and is appreciative of their efforts.

Mr. Fry said many Task Force members are familiar with this issue where they are trying to understand the rules behind CTLs. There was clear guidance in the P&P Manual, but some companies were interpreting a little bit differently. Companies know
Draft Pending Adoption

now that a CTL as defined in the P&P Manual has to be filed with the SVO. There are other transactions that do not fit the CTL guidance but have been previously coming in under the FE process. The Task Force is looking at these transactions now, such as ground leases and other structures that have performed very well over the years. My. Fry said that the Task Force should permit insurers to report these securities as they have in the past until the Task Force makes a final decision. He said he hopes that will be by year-end or 2020. He asked if any Task Force members objected to issuing an instruction to insurers to continue reporting these other transactions as they have done in the past until the Task Force makes a policy decision, and there were no objections from Task Force members. Mr. Fry asked Mr. Therriault to include that instruction in the minutes and the meeting summary

David Persky (TIAA) and Rej Reese (TIAA) thanked the Task Force and SVO staff for the engagement with industry. They said they appreciate all the effort and focus on this matter and look forward to the continued engagement in coming up with a solution—particularly keeping year-end in mind, as well as making sure that they help to provide any examples that the Task Force or SVO staff need to get to that solution.

Mr. Fry said he appreciates everyone’s efforts in working towards a solution.


Julie Gann (NAIC) said this is part of the coordination efforts of the Statutory Accounting Principles (E) Working Group. Working Group and this Task Force just to highlight a few of the things that the Working Group has done that would be of interest to the state insurance regulators and interested parties of this Task Force.

Ms. Gann said the Working Group adopted four items:

- **Bank Loans Referrals/Collateral Loans** – Although the Working Group is still discussing bank loans in response to the Task Force referral, the Working Group adopted revisions to SSAP No. 21R—Other Admitted Assets pertaining to collateral loans. These revisions clarify that an investment in another SSAP—such as an investment in scope of SSAP No. 26R—does not become a collateral loan in scope of SSAP No. 21R simply because it has been “sweetened” with additional collateral. The Working Group plans to continue discussing bank loans and hopes for a response back to the Task Force in the next year.

- **Affiliated Investments** – The Working Group adopted revisions to SSAP No. 25—Affiliates and Other Related Parties, to clarify the principles for classifying related party and affiliate investment transactions. This guidance clarifies that the mere presence of a nonrelated party intermediary, or the presence of nonrelated party assets in a structure predominantly comprised of related party investments, does not eliminate the requirement to assess and identify the transaction as a related party (or affiliated) arrangement. The guidance requires consideration to be given to the substance of the transaction and the parties whose action or performance materially affects the insurance reporting entity holding the security.

- **Mortgage Loans** – The Working Group adopted revisions to SSAP No. 37—Mortgage Loans to further clarify the exclusion of funds/securities from the scope of the standard (specifically excluding bundled funds) and to clarify what is required to acquire a mortgage loan through a participation agreement.

- **NAIC Designations by Lot** – The Working Group adopted revisions to SSAP No. 43R to clarify that investments with differing NAIC designations by lot (which potentially only occur with financially modeled securities) shall be reported in the aggregate at the worst NAIC designation, or separately by each applicable NAIC designation. The guidance does not permit reporting the weighted average of NAIC designations. It is expected that this will be a limited occurrence with the elimination of modified filing exemption.

Ms. Gann said the Working Group exposed the following four items:

- **Preferred Stock** – The Working Group exposed a proposed issue paper proposing substantive revisions to SSAP No. 32R—Preferred Stock as part of the investment classification project. This issue paper proposes to revise definitions, measurement and impairment guidance for these investments.

- **Rolling Short-Term Investments** – The Working Group exposed revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments to incorporate principle concepts in classifying investments as cash equivalents or short-term investments. The proposed revisions will require long-term investment reporting (complying with long-term investment provisions) for investments that are not expected to be terminated on the short-term maturity date,
Draft Pending Adoption

items that are renewed/rolled at the maturity date and items that are terminated with reacquisition of the same (or substantially similar asset) within one year of the termination date. In short, it tries to prevent investments from being repeatedly reported as short-term investments. There are specific exclusions to this guidance to avoid unintended consequences for short-term investments that are expected to be regularly renewed and rolled. As such, the proposed revisions would not include any nonaffiliated SSAP No. 26R investments. It would include affiliated SSAP No. 26R investments, all SSAP No. 43R investments and anything that would be reported as a BA investment if not reported as short-term.

- **Equity Instruments in SSAP No. 43R** – The Working Group exposed revisions to SSAP No. 43R to exclude investments with underlying equity investments from scope. This agenda item was drafted initially to capture collateralized fund obligations (CFOs). These are Schedule BA investments—such as joint ventures, private equity investments, hedge funds, etc.—that are put in trust and then issue “securities” that are based on the expected gain from those equity investments. This is basically a repackaging of equity instruments (which would be on Schedule BA) to reflect debt instruments in scope of SSAP No. 43R and reported on Schedule D-1. The exposure has been expanded to capture all instruments that reflect underlying equity investments to ensure such transactions are not captured through other designs.

- **Other Derivatives** – The Working Group re-exposed revisions to SSAP No. 86—without revisions from the prior exposure—on the guidance for reporting “other derivatives.” Other derivatives include all derivative transactions that are not used in hedging, income generation or replication programs. The guidance indicates that these instruments shall be reported at fair value and nonadmitted.

Ms. Gan said the Working Group deferred/discussed the following items:

- **Working Capital Finance Investments** – The Working Group directed NAIC staff to prepare proposed revisions to SSAP No. 105R—Working Capital Finance Investments in response to the Task Force’s referral. These edits will initially only reflect six of the recommendations and will not include the following:
  
  o Lowering the credit quality of the acceptable obligors from NAIC 1 and NAIC 2 to allow NAIC designations of NAIC 3 and NAIC 4.
  o Allowing credit substitution methodology for unrated subsidiaries.
  o Removing the statement that the reporting entity may need to seek approval from the domestic insurance regulator as this is a statement rather than an explicit requirement.
  o Changing the reporting requirements to move the working capital finance investments (WCFIs) from Schedule BA – Other Assets, to Schedule DA Short-Term Investments

  It is anticipated that SSAP No. 105R will be exposed in the interim or at the Fall National Meeting. (Comments can be provided on the edits reflected, as well as the elements not reflected.)

Ms. Gann said the comment deadline for new exposures is Oct. 11.

9. **Heard an NAIC Staff Report on the Impact of RMBS/CMBS Price Breakpoints with the Upcoming Change in NAIC Designation Categories**

Eric Kolchinsky (NAIC) said for model RMBS/CMBS, the NAIC provides a series of breakpoints to companies and then use set designations with the removal of the MFE approach, which is currently the only approach that uses breakpoints to set designations. The consensus on the NAIC staff side is that at some point, the NAIC should align the RMBS/CMBS modeling to provide a single designation. Mr. Kolchinsky said that is something that can be done analytically. However, he said this issue is being raised today mostly because of some of the technical issues and the cost involved potentially of building out a separate system having 20 breakpoints if in the future that system may go away.

Mr. Therriault (NAIC) said that the NAIC recognizes with the expansion to the NAIC designations to NAIC designation categories, 20 additional points exist for granularity. With the individual security of the price breakpoints, that actually has to expand out to 19 columns of price breakpoints that insurance companies will need to ingest within their investment accounting platforms to determine what the designation and designation category will be. He said the NAIC can produce such a file, but there was concern that this will be very expensive for insurance companies. There was also a concern that if state insurance regulators wanted to go to a single NAIC designation analytical answer or modelled answer, this would be a good time to consider the change before insurance companies had to modify their investment platforms to accommodate the new file format.
Draft Pending Adoption

Mr. Therriault said that SVO and SSG staff are interested in hearing industry feedback and that state insurance regulators desire to move to a single designation on each security.

Mr. Fry said one of the issues is timing. Eventually, the NAIC will go to 20 designation categories and get the bond factors finalized. At the same time in a separate project that the Task Force talked about in the past is modelling RMBS/CMBS securities and using breakpoints, but the Task Force has been hindered in the past to stop using breakpoints. He said the SSG can model these securities and come up with one designation, no matter what price it is held at. There is momentum on that change, and it is just a matter of when to do that. He said it might make sense to just align it up so everything gets an NAIC designation category when the Task Force decides on the final bond factors. The thought is that it would be more efficient for the vendors, and the companies would save a lot of money instead of having to turn around to get to 20 breakpoints and then a year or two later if the Task Force decides to go to a new modeling technique, then further changes will need to be made. It seems that it would be disruptive to industry. My Fry requested NAIC staff to put together a memorandum that the Task Force can look at that encapsulates all these concepts that were discussed.

Mr. Bean said that industry had some of these discussions a couple of years back. He thinks industry will want to sit down and regroup to formulate its thoughts and that he looks forward to seeing the memorandum and working with the SVO and the SSG.

10. Heard an NAIC Staff Report on the “Bespoke” Securities

Mr. Kolchinsky said as part of the Task Force’s work, it has found a number of securities where the risk is not adequately reported. A number of these securities were held by troubled companies. SVO staff and SSG staff started calling these securities “bespoke.” The term in finance comes from the London financial area, where bankers get their suits done “bespoke.” Likewise, these financial instruments get done for a single client; they are not done for the market. SVO staff and SSG staff are concerned about them because they are not exposed to market discipline.

Mr. Kolchinsky said the best way to introduce bespoke securities is to provide some examples, such as phantom principal (i.e., PPNs). The security held by the insurer has a principal amount of $100. The amounts have been changed for confidentiality reason. It is held at an NAIC 1, and the SVO estimates designation would be an NAIC 5. The security is issued by a trust, which holds $45 of an unrelated publicly rated NAIC 1 bank 30-year note and $55 of unknown and unrated additional assets. The note itself is rate and gets an NAIC 1, and the way you span the $45 of the NAIC 1 bank note to the $100 of NAIC 1 is the interest payments on the phantom note are much less than on the underlying bank note. That interest goes to pay down the principal. That interest payment is not assigned any credit risk. There is phantom interest created by lowering the coupon of the phantom note. There is no market discipline because no investor would accept a lower coupon for the same risk.

Mr. Kolchinsky said that the other example that NAIC staff have seen are where underline for the bespoke securities are things that are inadmissible or affiliate assets going into the underlyng of these notes. NAIC staff have seen inadmissible assets such as aircraft go into these notes, along with securities that are circular—a couple of securities pointing at each other for credit support is not clear what it is that is providing it. A part of the problem is that these issues cannot be seen from the face securities or from the name of the security. They often have nice, even friendly names, so one has to dig deeper to see the documents and the portfolio to see what is going on in these securities. There are many others, but these were picked because the others cannot be discussed due to confidentiality.

Mr. Kolchinsky said an issuer or an insurer can create one of these securities, get a rating from a CRP—publicly or privately (more likely privately)—and the insurance company can buy it. There is no public scrutiny at all. The focus here is on market scrutiny of the product that is going on an insurer’s balance sheets. The NAIC cannot look into the security. NAIC staff have tried to define these bespoke securities as: 1) not broadly syndicated (i.e., owned by many parties); 2) created by or for one or a few related insurance companies as an investment; and 3) assigned a credit rating by only one NAIC CRP, often via private rating.

Mr. Kolchinsky said the focus here is market discipline. He said that he would like to separate securities that are private and bespoke because the issuer is a private company, but multiple investors compete to make the investment and review the transaction from securities whose terms and structure are deliberately kept private to keep them from being transparent to the market and state insurance regulators. He said that he would like to add transparency that would allow NAIC staff to see inside the security. There are three main challenges in terms of implementation: 1) definitional. Because they are bespoke, all possible variants cannot be defined; 2) locating bespoke securities in insurance company portfolios because no third-party data providers can provide any information on them like they would with other public securities; and 3) resolution. NAIC staff do not have the authority to do anything about these securities if they find them.
Draft Pending Adoption

One of the approaches the SVO and SSG have been thinking about and want to pursue with the Task Force is a “red flag” approach. A lot of these bespoke securities have red flags, but the converse is not true; just because a security has a red flag does not mean that it is bespoke. Some red flag criteria are: 1) rating from a single rating agency; 2) private letter rating; 3) assets backing the security were primarily owned by insurer or affiliates before that transaction and reported differently (i.e., regulatory arbitrage); 4) assets backing the security may not generate bond cash flows (i.e., contractual requirements to pay periodic principal and interests) or they are equity securities; 5) the insurer or affiliated group are the sole investors in security; and 6) the affiliate of company is underwriter or sponsor of the security. The SVO and SSG staff would like to continue working on this framework and if the Task Force agrees, an issues paper will be drafted including a proposed regulatory analysis on how to deal with bespoke securities for a future meeting.

Mr. Fry said that these are hard to describe and as a state insurance regulator are hard to picture. He said that he would like to start with an issues paper and let the SVO work on this behind the scenes and draft something that the Task Force can expose later. He said this was an opportunity to give everyone a notion that this kind of work is coming.

Mr. Everett said he understands from the presentation that there is no idea how spread out these are or how frequent they appear. Mr. Kolchinsky said it is difficult because they are hard to find. They have been commonly found in troubled companies, they are very hard to find. Mr. Everett asked if the companies in which they have been found represent a percentage of the portfolio. Mr. Kolchinsky (NAIC) said it is difficult to say as the NAIC must keep the company confidential. He said it is something NAIC staff can try to look into a part of the research for the issues paper—what they have seen and how much of their assets it represents.

Mr. Therriault said they are quite substantial in terms of what their investments were and as Mr. Kolchinsky mentioned, these are very hard to find. Often, they are privately rated securities. Unless one looks at the legal agreements, the indentures behind them, the transaction detail will not be seen. The name on the Schedule D blanks does not give sufficient information to understand what the risks are within the investment. This is one of the reasons NAIC staff brought the PPN to the Task Force’s attention and why the structured notes definition was adopted by the Statutory Accounting Principles (E) Working Group. Mr. Therriault said that on face value, the securities look like benign assets, but as one digs in, one realizes there is more complexity to them. He said it is important to understand what the risk is.

Mr. Spudek asked if these coming into the system and appearing on Schedule D through the FE process. Previously, these securities would have come through the SVO for review and the SVO could act on them. Mr. Therriault said most of these have become visible to SVO staff because they were filed as a private letter rating. SVO staff are seeing the underlying structure in this analysis, but they still follow the FE process, and SVO staff have no authority or control to change them. The CRP analysis is not required for private ratings and without it, SVO staff would still not know what they were.

Mr. Fry said that as the Task Force does this, it is going to be careful and hit securities unnecessarily. However, he said the Task Force needs to find a way to focus on these securities and correct them in the system.

11. Heard an NAIC Staff Report on the Infrastructure Investments

Mr. Kolchinsky said wanted to notify the Task Force and industry on a Center for Insurance Policy and Research (CIPR)-led effort to create a research project around infrastructure. A request for information about infrastructure and insurance company investments in infrastructure will be sent to the Task Force interested parties list and it will also be on the CIPR’s website. The request asks any industry and any other persons who have information to get involved in this research project.

Having no further business, the Valuation of Securities (E) Task Force adjourned.
The Valuation of Securities (E) Task Force met via conference call May 30, 2019. The following Task Force members participated: Robert H. Muriel, Chair, represented by Kevin Fry (IL); James J. Donelon, Vice Chair, represented by Stewart Guerin (LA); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kathy Belfi (CT); Trinidad Navarro represented by Rylynn Brown (DE); David Altmaier represented by Joe Erhart and Robert Ballard (FL); Doug Ommer represented by Carrie Mears (IA); Dean L. Cameron represented by Eric Fletcher (ID); Vicki Schmidt represented by Tish Becker (KS); Gary Anderson represented by John Turchi (MA); Al Redmer Jr. represented by Matt Kozak (MD); Chlora Lindley-Myers represented by Debbie Doggett (MO); Bruce R. Ramge represented by Lindsay Crawford (NE); Marlene Caride represented by John Sirovetz (NJ); Linda A. Lacewell represented by Jim Everett (NY); Glen Mulready represented by Joel Sander (OK); Kent Sullivan represented by Amy Garcia (TX); Todd E. Kiser represented by Jake Garn (UT); Scott A. White represented by Doug Stolte (VA); Mike Kreidler represented by Patrick McNaughton and Tim Hays (WA); Mark Afable represented by Randy Milquet (WI).

1. Received a Referral of the Statutory Accounting Principles (E) Working Group on Structured Notes and a Proposed P&P Manual Amendment to Update the Definition and Instructions for Structured Notes

Mr. Fry said this agenda item is a referral from the Statutory Accounting Principles (E) Working Group on structured notes. The referral clarifies the accounting and reporting guidance for structured notes. A structured note is defined as an investment that is structured to resemble a debt instrument, where the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due. Structured notes reflect derivative instruments—i.e., put option or forward contract—that are wrapped by a debt structure. The adopted revisions include the following:

- **Statement of Statutory Accounting Principles (SSAP) No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments:** Derivative instruments shall not be reported as cash equivalents or short-term instruments regardless of their maturity date.
- **SSAP No. 26R—Bonds:** Structured notes are explicitly excluded from the scope of SSAP No. 26R. Although these instruments are structured to resemble a debt instrument with a “debt wrapper,” these instruments are not bonds.
- **SSAP No. 43R—Loan-Backed and Structured Securities:** Structured notes that are mortgage-referenced securities are in scope of SSAP No. 43R.
- **SSAP No. 86—Derivatives:** Structured notes, excluding mortgage-referenced securities in scope of SSAP No. 43R, are considered derivative instruments and shall be captured in scope of SSAP No. 86.

The adopted statutory accounting revisions were adopted with a Dec. 31, 2019, effective date. The Working Group has requested that the Task Force revise the structured note definition in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual), either by adopting the Working Group definitions or by referring to the SSAP No. 86 definition to ensure continuity. Mr. Fry asked the Securities Valuation Office (SVO) to draft a P&P Manual amendment from this referral and asked Charles Therriault (NAIC) go over the proposed amendment.

Mr. Therriault explained that the Working Group adopted a definition for structured notes that brings financial activity in scope of SSAP No. 86 (Exhibit One). The new guidance defines structured notes as “an investment that is structured to resemble a debt instrument, where the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due.” The determination removes these instruments from being in scope of SSAP No. 26R and, with the exception of mortgage-referenced securities, SSAP No. 43R. The SVO agrees with the Working Group and recommends to the Task Force in this amendment that the existing definition and text in the P&P Manual be deleted, and a reference to SSAP No. 86 be added, along with a note on the guidance for mortgage-referenced securities. The proposed amendment makes these changes and includes two updates to the disclosure on securities not eligible for filing exemption (FE) to refer to mortgage-referenced securities as not being FE eligible and structured notes as being explicitly excluded from SSAP No. 26R and SSAP No. 43R. Mr. Therriault recommended that the Task Force expose the amendment for a 30-day public comment period.
Mr. Everett had one technical question about a phrase in the definition that says, “although in the form of a debt instrument.” He asked why that would be included. He also asked what type of instruments the Task Force was trying to catch here.

Mr. Therriault explained that often times, instruments may have some kind of derivative that will impact the ability for principal to be returned at the end. There might not be any principal returned at the end, depending on what happens with the derivative instrument. It appears to be a bond, however, it is actually a structured investment that has both a bond and option or derivative characteristics embedded in it.

Julie Gann (NAIC) explained that on pages two and three of Attachment A is the structure note Form A that was discussed and adopted by the Statutory Accounting Principles (E) Working Group. There are some examples of the language that is included in the prospective of these instruments, and the way they are structured kind of resembles a debt instrument. There is an amount that could be paid at a certain maturity date in the future, but the issue is that the actual amount to be paid at that time could be significantly less than the original principle amount.

Michael Reis (Northwestern Mutual) explained that part of the comment letter to the Statutory Accounting Principles (E) Working Group was to make sure that the definitions in SSAP No. 86 are identical to what is in SSAP No. 26R. There was some feedback that the definitions are slightly different, which is making the industry uncomfortable. Mr. Reis is anticipating that the SVO will take the definition in SSAP No. 86. The definition that got scrutiny from interested parties was from SSAP No. 26R and that definition does not have the same language as SSAP No. 86. The definition in SSAP No. 26R should be the one that is used.

Ms. Gann explained that the intent was to make those definition identical, and she will review them.

Mr. Everett made a motion, seconded by Ms. Belfi, to receive the referral from the Statutory Accounting Principles (E) Working Group that requests changing the guidance on structured notes and exposing the referral, and a proposed amendment updating the guidance in the P&P Manual for structured notes and their FE eligibility for a 30-day public comment period. The motion passed unanimously.

2. Heard a Joint NAIC Staff and Industry Report on the Project to Review Existing CTL Guidance and Possible New Guidance on Other Lease-Based Transactions

Mr. Fry said the next item on the agenda is to hear an update on the project to review existing credit tenant loan (CTL) guidance and possible new guidance on other lease-based transactions. He asked Mr. Therriault to give his update.

Mr. Therriault said since the Spring National Meeting, the Private Placement Investors Association (PPIA), along with the American Council of Life Insurers (ACLI) and the Lease-Backed Securities Industry Group, have provided the SVO with the rating agency methodologies applicable to CTL transactions, along with their summarization of these methodologies and a proposed minimum criterion. They also provided a high-level summary, by dollar value, of the leased-based transactions reported as filed with the SVO versus those that were not filed. For CTLs, they reported that approximately 85%, $20.9 billion of the $24.7 billion, were filed with the SVO. The number of unique transactions was not reported. For all other lease or credit supported transactions, they reported a somewhat inverse relationship with approximately 24%, $1.1 billion of the $4.5 billion, filed with the SVO; again, He does not know how many unique transactions that represents.

A conference call was held with this group on May 23, 2019. The SVO staff has begun reviewing these materials provided, but it has not formed an opinion. He hopes to have additional direct discussions with this group in the future to better understand these other lease or credit supported transactions. A cursory review of the rating agency methodologies seems to reflect what the SVO expected—some appear generally consistent with the current policy and others do not. He continues to believe that any substantive changes would require a referral to the Statutory Accounting Principles (E) Working Group. As Mr. Therriault mentioned earlier, his staff are still reviewing these materials. He envisions that next steps would include receiving representative transaction documents from this group that the SVO staff will review. It is uncertain if the SVO will be able to arrive at an opinion before the Summer National Meeting; the Fall National Meeting is more likely. The SVO will continue to work with the industry on this important initiative. He recommends that companies file their CTLs with the SVO. As with any filing, the sooner the better, before the SVO gets into the heavier filing associated with the second half of the year. In discussions with Financial Regulatory Services (FRS) staff, it was suggested that any non-conforming CTL could be reported on Schedule BA instead of the mortgage schedule.
Mr. Fry thanked Mr. Therriault. He was present at the April 23, 2019, conference call with the Lease-Backed Securities Industry Group, the PPIA and some of the players that are involved with the asset classes. He thought it was a positive discussion; including, about possible minimum standards. CTLs have to be filed; the Task Force has already determined that. If there is a CTL that meets the definition in P&P Manual, it must be filed. There is the question of what the Task Force does with those that are like CTLs, and whether ratings can even be used. As the Task Force works through covering this swath of securities; the SVO could be involved. The SVO is looking at the proposal that the industry presented, and that will probably be what will be heard next.

John Garrison (John Hancock) said John Hancock’s focus, as Mr. Fry correctly said, is more on a broader class of lease-backed securities that fall outside the specific definitions of CTLs that are currently in the P&P Manual. John Hancock agrees that CTLs, as described and designated in the manual, definitely need to be filed. He hopes that through this discussion with the SVO that new guidelines and minimum standards can be agreed on and proposed to the Task Force for this broader class of lease-backed securities. As an investor, these are great investment options for insurance companies based on their stable cash flows, strong credit profiles, and typically long tenures. He thought it was a very productive meeting in Springfield, IL. He looks forward to working with Mr. Therriault and his staff. The next step is to get representative transactions in front of the SVO and allow them to understand the class a little bit better. John Hancock looks forward to working with the Task Force and the SVO in the coming weeks and months.

Mr. Fry thanked the SVO staff and the industry for all their hard work and collaboration.

3. Received and Discussed a Referral of the Statutory Accounting Principles (E) Working Group on Regulatory Transactions and Received a Proposed P&P Manual Amendment to Add Instructions for New Administrative Fields “RTS” and “RT”

Mr. Fry said the next item on the agenda is a referral from the Statutory Accounting Principles (E) Working Group requesting that the Task Force add new reporting codes for investments that meet the definition of a regulatory transaction within the P&P Manual. Given the P&P Manual restrictions on reporting NAIC designations for regulatory transactions, the Working Group noted that there was no reporting mechanism to identify regulatory transactions or an SVO analytical value for RBC assessment on the investment schedules. He asked the SVO to draft a P&P Manual amendment from this referral and asked Mr. Therriault to go over the proposed amendment.

Mr. Therriault said the referral from the Working Group requests that the Task Force address reporting for regulatory transactions. The P&P Manual defines the term “regulatory transactions” and provides that such transactions: 1) are not eligible for credit assessment by the SVO; 2) are not eligible for FE; 3) cannot be self-assigned the administrative symbol Z under the 120 rule; 4) cannot be self-assigned as 5GI securities; and 5) cannot be entered into NAIC systems maintained for the Task Force. The P&P Manual also provides that a domiciliary state insurance department may request SVO or Structured Securities Group (SSG) assistance in the assessment of a regulatory transaction, with the understanding that the state can adopt the SVO or SSG work product as its own, but the determination is a state determination and not an NAIC work product. He agrees with the Working Group that there is no specific instruction for reporting regulatory transactions, and reporting entities do not have any available reporting options when investment schedules require an NAIC designation.

On April 6, 2019, the Working Group adopted a revised NAIC staff recommendation to add reporting codes for the investment component of regulatory transactions. Under the adopted procedure, a reporting entity would use the code “RTS” when the domiciliary state has received assistance from the SVO or the SSG in reviewing a regulatory transaction. In those cases, the code would be reported with the “analytical value” (a new term defined in the amendment) assigned by the SVO or the SSG and given to the state.

For all other regulatory transactions, when the domiciliary state did not ask the SVO or the SSG for assistance or those where the SVO or the SSG was unable to determine an analytical value for the transaction for the state, the code “RT” would be used. This code would be reported with an NAIC 6 designation for measurement and risk-based capital (RBC) assessment.

These codes are specific to Schedule D, Part 1 reporting because those schedules require reporting an “NAIC designation” for all securities. A reporting entity may identify a regulatory transaction on other investment schedules, but such other schedules do not require that an NAIC designation be reported, such as Schedule BA.

Mr. Therriault recommended this proposed amendment to the P&P Manual to add these two new reporting codes for regulatory transactions, along with updates on their definition being exposed for a 30-day public comment period. If the Task Force adopts
the proposed amendment, further referrals to the Blanks (E) Working Group to add the codes to the SVO Administrative Symbol list in the statement instructions would be necessary.

Mr. Kozak made a motion, seconded by Mr. Fletcher, to receive the referral from the Statutory Accounting Principles (E) Working Group requesting new reporting codes for the investment component of regulatory transactions and expose the referral and proposed P&P Manual amendment to update the guidance and reporting codes for these regulatory transactions for a 30-day public comment period. The motion passed.

4. **Discussed a Referral to the Blanks (E) Working Group to Add a NAIC Designation on Comprehensive Fund Instructions**

Mr. Fry said the next item on the agenda is a referral from the Task Force to the Blank (E) Working Group requesting that the Schedule BA and annual financial statement instructions for private funds captured on Schedule BA be modified to say that private funds purchased on or after Jan. 1, 2019, are not eligible for FE and can only be accorded fixed-income treatment if designated by the SVO, and private funds purchased prior to Jan. 1, 2019, can continue to be reported on the basis of a public NAIC credit rating provider (CRP) credit rating with annual surveillance until the private fund shares are sold or disposed of, provided that the insurer also reports the investment on the fund general interrogatory or until the public NAIC CRP credit rating is withdrawn. The request also asks the Blanks (E) Working Group to develop the fund general interrogatory necessary to monitor and report private funds purchased prior to Jan. 1, 2019, that will be assigned an NAIC designation based on the public NAIC CRP credit rating with annual surveillance. As this is a referral to the Blanks (E) Working Group, no action is required.

Mr. Therriault said he would like to mention a related concern. The language adopted by the Task Force for “Investments in Funds Eligible for Fixed Income-Like Treatment” did not carry forward a specific phrase, “… receives a public rating with annual surveillance from a CRP,” from the 2018 P&P Manual in Part Three, Section 5.b. Mr. Therriault noticed this oversight when preparing this referral. With the Task Force’s permission, he requested either drafting a non-substantive amendment or directly taking an instruction to add back this text to eliminate any unintended ambiguity in the grandfathering provision for private funds reported on Schedule BA and acquired prior to Jan. 1, 2019; private ratings are excluded, as was specified in the 2018 P&P Manual.

Mr. Fry said the referral already went, so that is just informational; and the Task Force got the request to clarify that the Task Force is putting this phrase after a place in the manual that says “receives a public rating with annual surveillance from the CRP.” He said this will make sure that it has a rating, and that it is annually monitored. Mr. Therriault said it will also exclude private letter (PL) ratings for these funds. Mr. Fry asked whether the Task Force needs to expose this or direct Mr. Therriault to add that phraseology. Mr. Therriault said he could take instructions either way: to draft and expose an amendment to make the minor text change or take direct instructions to make a minor editorial update. The instruction is in the 2018 P&P Manual, so it is an existing policy that was adopted.

Mr. Fry said unless there are any objections from the Task Force members, he directed the SVO staff to make this non-substantive change to add back the phrase from the 2018 P&P Manual “… receives a public rating with annual surveillance from a CRP.” To eliminate any ambiguity, the private ratings are excluded.

5. **Discussed a Referral to the Capital Adequacy (E) Task Force on Comprehensive Fund Instructions**

Mr. Fry said the next item on the agenda is a referral from the Task Force to the Capital Adequacy (E) Task Force requesting that the Valuation of Securities (E) Task Force consider formally integrating the comprehensive instructions for mutual funds recently adopted into the NAIC RBC framework. The primary financial solvency tool of the Valuation of Securities (E) Task Force is a number of related analytical methodologies for the quantification of non-payment risk. These tools have often been used to identify and facilitate investments that provide insurers a needed return at a lower non-payment risk. The referral requested that the Capital Adequacy (E) Task Force consider attributing the bond RBC factors to all bond and preferred stock funds. This approach is easy to implement and consistent with past NAIC practice, including both the role of the Valuation of Securities (E) Task Force in identifying the risks in securities and the practical approach expressed in the administration of the RBC framework, which is based on default characteristics of corporate bonds but applied to many other instruments with risk and default characteristics unlike those of corporate bonds.

The Task Force adopted the methodology that is currently used with exchange-traded funds (ETF) for use on bond mutual funds. All of this is housed in a new comprehensive section for all fund investment activity. The Task Force is already using this methodology for ETFs and private funds, so the referral recommends that the Capital Adequacy (E) Task Force consider
using this same methodology for bond mutual funds since they are very similar. The Capital Adequacy (E) Task Force can choose to use another method to consider this risk. The referral has already been sent to the Capital Adequacy (E) Task Force; this discussion is informational.

Mr. Everett said he would like to request a supplement to the referral to the Capital Adequacy (E) Task Force to examine the applicability of current RBC factors to the bond and preferred stock funds to identify risks present in the securities that are not covered by RBC factors and refer back to the Valuation of Securities (E) Task Force for an assessment of the risks not covered by them. It does so for a number of reasons; the first is that the Task Force is alone among markets financial analyst commercial and securities, laws and organizations, national and international regulations, and regulators and non-governmental organization (NGOs) in granting these funds bond recognition. The Task Force should consider the capital structural differences of varying funds that can alter their investment risks of type of varying investment funds. They can alter investment risks significantly (e.g., closed-end funds can maintain lower cash reserves than open-end funds; they are much more aggressive in their borrowing). Closed-end funds are better able to issue senior securities than open-end funds, and they expose investors to increase leverage. Their liquidity is significantly lower than open-end funds. The Task Force should: 1) consider how they handle the funds that issue senior securities or hold leverage investments in the portfolio that is derivatives or repurchase agreements; 2) identify the practices that mutual funds use to engage in borrowing or leveraging; and 3) identify the sources of financing. While these are regulated by the U.S. Securities and Exchange Commission (SEC), which is one of the criteria, the limits on funds composition begin with the consideration of whether the name actually matches that which is in the fund. The Task Force should also consider what RBC related factors should be included in the approaches used to make NAIC designations or what additional investment factors should be considered. The credit assessment and equity valuation are fundamentally different disciplines. If the Task Force is considering authorizing a treatment for a universe of 2000 new funds, then the Task Force should: 1) wait for the Capital Adequacy (E) Task Force to consider it; 2) examine current approaches for their conformance to RBC factors; and 3) adjust those approaches for factors not included in the RBC factor considerations. Again, with those considerations, Mr. Everett would like to request a supplement referral to examine the applicability of current RBC factors to bond funds and preferred stock funds to identify the risks present in the securities that are not covered by those factors and refer back to this Task Force for an assessment of those risks not covered by the RBC factors.

Mr. Fry said this sounds like substantially more than a supplement to what was already sent to the Capital Adequacy (E) Task Force. These comments may be better suited for the Capital Adequacy (E) Task Force. The referral informed the Capital Adequacy (E) Task Force of what methodology this Task Force uses to analyze risks. The Task Force has been reviewing ETFs, private funds, and other fund types for over 30 years. These comments would be very well served in the form of comments from New York directly to the Capital Adequacy (E) Task Force. Mr. Fry said he was comfortable with the process of having the SVO look at all of these funds and their rules, and consider the risks mentioned when they assign an NAIC designation.

Mr. Everett said he was not saying that the SVO is not reviewing the funds. He was suggesting that given the variety of these entities, it is incumbent upon the state insurance regulators on the Task Force to understand what is being considered. If the Task Force is looking at comprehensive treatment for 2000 new funds, then perhaps it is time to look at these items because the ETF authorization and methodology was adopted when there were essentially 13 ETFs held by insurance companies.

Mr. Fry said the Capital Adequacy (E) Task Force would be a good forum for this discussion, and this is the time to discuss those issues with the Task Force as they consider using the status quo methodology. He said given that this is a referral, no action is required.

6. Received a Proposed P&P Manual Amendment to Remove Obsolete MFE Instructions

Mr. Fry said the next item on the agenda is a proposed P&P Manual amendment to remove obsolete modified filing exempt (MFE) instructions. He asked Mr. Therriault to go over the proposed amendment.

Mr. Therriault said on Oct. 11, 2018, the Valuation of Securities (E) Task Force adopted an amendment to delete the MFE provisions from the P&P Manual and directed a referral to the Statutory Accounting Principles (E) Working Group recommending the deletion of the MFE provisions from SSAP No. 43R. In the period leading up to the Spring National Meeting, representatives of the ACLI, the North American Securities Valuation Association (NASVA), and the PPIA identified a reference to MFE in Part Three, Section 1.b. of the 2018 P&P Manual and urged the removal of the reference from the 2018 P&P Manual and from the draft 2019 P&P Manual as it was extraneous. Given the deletion of the MFE provisions from the P&P Manual, it was inconsistent to leave this one portion in the PL rating section. The Task Force agreed to consider this as a conforming amendment. NAIC Staff have examined the amendment adopted on Oct. 11, 2018, and it discovered that the
amendment focused solely on text in Part Seven of the P&P Manual, which is concerned with operations of the SSG. This unintentionally ignored the MFE reference and text in Part Three. The SVO staff agreed that this residual MFE instruction should be removed, and it recommended that this amendment be exposed for a 30-day public comment period.

Mr. Sirovetz made motion, seconded by Ms. Mears, to expose this amendment to the P&P Manual to remove the outdated residual MFE text for a 30-day public comment period. The motion passed.

7. Discussed a Referral to the Blanks (E) Working Group on an NAIC Designation Modifier and NAIC Designation Category Along with the SVO Administrative Symbol

Mr. Fry said the next item on the agenda is a referral to the Blanks (E) Working Group on NAIC designation modifiers and NAIC designation categories, along with the SVO administrative symbols. The Task Force adopted on June 11, 2018, a more granular NAIC designation category framework. The new NAIC designation category applies wherever an NAIC designation is reported and produced by the SVO, independently or based on CRP credit ratings for FE and PL securities, as well as those assigned to residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) based on financial modelling by the SSG. Upon the determination of an NAIC designation, the SVO or the SSG will produce NAIC designation categories that are a subset of NAIC designations. “NAIC designation category” means and refers to 20 more granular delineations of credit risk in the NAIC 1 through NAIC 6 credit risk scale used by the Task Force to relate credit risk in insurer-owned securities. This granular level of credit risk can be used by the Capital Adequacy (E) Task Force to assign granular RBC factors when it adopts them. In the meantime, this additional level of credit risk provides NAIC members additional insight into the risk of insurer investments.

The referral requests that the Blanks (E) Working group modify the financial statement instructions for Schedule D; Schedule D, Part 2, Section 1; Schedule D, Part 2, Section 2; and Schedule BA for reporting after Jan. 1, 2020, to include the following reporting fields: NAIC designation; NAIC designation modifier; and NAIC designation category. These fields are to be used in conjunction with the separate “SVO Administrative Symbol” field to convey information about the investment.

As this is a referral to the Blanks (E) Working Group, no action is required.

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

W:\National Meetings\2019\Summer