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

Dear Ms. Mears:

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

The undersigned (ACLI, PPIA, and NASVA) appreciate the opportunity to comment on the exposure referred to above that was released for comment by the VOSTF on December 2, 2023. As noted by both industry and regulators, the P&P Manual is often difficult to navigate and often includes conflicting and confusing language. Therefore, we agree with the premise of the exposure that an NAIC Designation be defined once in a single uniform definition (i.e., not in both Part 1 and Part 2 of the P&P Manual). Additionally, this is important in light of the SVO presentation at the December 2, 2023 VOSTF national meeting on the "History of Filing Exemption", which highlighted the significant changes of the objectives of the SVO and VOSTF since 1909, as well as the evolution of investments, reserving, business models, and NAIC roles and responsibilities.

Summarization of Key Points

The undersigned have several significant concerns leading to what we believe to be a fatal flaw with the definition of an NAIC Designation as proposed in the exposure. The remainder of this letter will detail these concerns.

In summary, the undersigned propose the following related to the exposure surrounding the definition of an NAIC Designation for the sake of transparency, clarity, and encompassing all risks that impact non-payment.

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

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1. Remove paragraph 88, consistent with the proposed deletions of all other P&P Manual language related to Subscript S non-payment risk.
2. Delete the sections as proposed by the SVO that discuss Subscript S non-payment risk elsewhere throughout the P&P Manual as we agree such language ambiguous, conflicting, and/or not relevant.
3. Amend the Definition of an NAIC designation as follows:

NAIC Designations represent opinions of gradations in credit quality identified by the NAIC 1 through NAIC 6 symbols (as modified by NAIC Designation Categories) which indicate the highest quality (least risk) to the lowest quality (greatest risk), respectively, and which reflect the likelihood of timely and full payment of principal and scheduled periodic interest, in accordance with the contractual terms of the debt instrument ~~regulatory objectives explained above~~, and the likelihood of principal and/or interest payment default. Where appropriate for a given investment, NAIC Designations shall reflect "tail risk" and/or loss given default. NAIC Designations and Designations Categories shall reflect the position of the specific liability in the issuer's capital structure, and all other risks that may impact the repayment of promised interest and principal in accordance with the contractual terms of the debt instrument ~~non-payment risks or non-payment risk mitigants~~. NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension, or liquidity risk. NAIC Designations should not capture risks (e.g., tail risk) if those risk are inconsistent with, or duplicative of, risks already captured and defined in the risk-based capital factors determined by CATF, as applicable.

In summary, the definition with the undersigned's proposed edits:

1. Capture all risks that impact credit quality, including all risks associated with non-payment,
2. Does not capture risks, beyond credit risk, such as assessing an insurer's ability to pay claims, and
3. Ensures risks (e.g., tail risks) are not double counted and are consistent with the risk-based capital factors under the responsibility of the CATF.

Detailed Concerns and Support for Key Points and Conclusions

To support these points and our conclusions, we detail our concerns with the proposal, including potential contradictions between other aspects of the NAIC's regulatory framework and within the definition itself.

The proposed paragraph 89 of Part 1 of the P&P Manual properly defines what an NAIC Designation represents in a single uniform definition with exception of the following:

1. Lack of transparency and relevancy surrounding Subscript S non-payment risk, and
2. The interaction with the risk-based capital factors as determined by CATF.

Both shortfalls can be addressed with the surgical edits proposed and are consistent with our many previous letters regarding needed transparency and relevancy surrounding Subscript S non-payment risk as well as with previous conclusions of the VOSTF.

On the face of it, the addition of “non-payment risk” to the definition of an NAIC Designation could seem rather innocuous. That is, consideration of any risk related to non-payment should seemingly be incorporated.

However, regulators and insurers continue to lack clarity as to the use, relevance and understanding of Subscript S non-payment risk. The concept of Subscript S non-payment risk has been included in the P&P Manual for decades, but we are unaware of its use and designation by the SVO (as incorporated within paragraph 89, prior to the SVO’s proposed changes) in any significant way, if at all.

Additionally, the SVO has not been able to succinctly define Subscript S non-payment risk over the last several years, which is coupled with the P&P Manual having many seemingly conflicting statements in relation to what it represents.

Therefore, there is insufficient transparency as to what Subscript S actually means, or how it will be used, which culminates in an inappropriate comingling of Subscript S non-payment risk within the definition of an NAIC Designation. More specifically, we note the following shortfalls:

1. Paragraph 88 is selectively moved from a P&P manual section related to notching, both for position in the capital structure and Subscript S non-payment risk, to immediately prior to the proposed new definition of an NAIC Designation.
2. Both the SVO and every rating agency we have talked to first assess the “credit quality of the issuer” and then notch that credit quality based on where the debt resides in the capital structure. Notching related to position in the capital structure is appropriate when it occurs in this manner.
3. However, incorporating Subscript S non-payment risk into a credit designation is highly ambiguous – notwithstanding the changing of “notched” to “shall reflect” in paragraph 89. This concern is further accentuated with the proposed addition of Subscript S non-payment risk via a reference to paragraph 88 referred to in point 1 above, along with the proposed deletion of all other elements of Subscript S non-payment risk from the P&P Manual.

The incorporation of Subscript S non-payment risk in the definition of an NAIC Designation and the reference to paragraph 88 merits further examination.

Paragraph 88 which was moved immediately prior to the definition of an NAIC Designation, including with the SVO’s proposed changes (highlighted), is included below:

> *An objective of the VOSTF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. NAIC Designations are ~~The SVO is~~ required to reflect ~~identify securities that contain~~ such*

contractional modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurers.

The first sentence is as follows:

An objective of the VOSTF is to assess the financial ability of an insurer to pay claims.

This objective of the VOSTF should be examined:

The SVO's presentation highlighted the significant changing role and evolution of the SVO and VOSTF over time, therefore, is this still an appropriate objective of the VOSTF? Or is it more appropriately the VOSTF's objective to oversee the SVO's assessment of credit risk? Further, if it is "an objective" of the VOSTF, it begs the following questions:

Question 1: Is it appropriate to selectively give prominence to this objective versus the other objectives of the VOSTF? If so, how is the VOSTF fulfilling the objective of assessing the ability of insurers to pay claims?

If regulators believe this is an objective of the VOSTF, it would be helpful for the VOSTF to state in writing how they are fulfilling this objective and how it falls under their responsibility and relates to an NAIC designation beyond assigning credit risk.

Question 2: Is the regulatory assumption that a fixed income investment called debt by its originator or issuer requires scheduled payments of interest and repayment of principal on a date certain still a relevant objective of the VOSTF?

Discussions with the SVO would suggest this is to be interpreted as a bond with a fixed schedule of pre-determined coupon and principal payments allowing for no potential deferral or PIK interest, no potential prepayment ability, and no potential extension terms, as these are considered non-payment risk. However, there are many valid examples of securities in the market that would appear to not meet this interpretation, but would be considered to have non-payment risk due to their contractual payment terms. For example:

1. A US agency mortgage-backed pass-through security as it is subject to both prepayment and extension risk even though it is repaid in accordance with the contractual terms and is guaranteed by the US government.
2. A security that can defer or PIK interest even though the contractual terms will require subsequent payment via capitalization of interest.

These examples may have been relevant at some point if the VOSTF was assessing the ability of insurers to pay claims, but that no longer appears appropriate. This is evidenced by the VOSTF decision in 2023 to identify securities that defer or PIK interest so regulators/LATF can see if companies are factoring in these features in asset adequacy testing (i.e., so they can assess the ability of an insurer to pay claims).

Further, extension, prepayment, and liquidity risk (i.e., the latter related to deferring or PIK interest) being incorporated into the definition of an NAIC Designation would appear to be in direct contradiction to other language long included within what an NAIC Designation represents,

and proposed to be retained, which we believe is appropriate and support. Specifically, it states, "NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk." Shouldn't an NAIC Designation represent the assessment of credit risk rather than have VOSTF/SVO assess the ability of an insurer to pay claims?

Question 3: Is this only related to contract modifications (third sentence in paragraph 88)? (i.e., not related to the original contract?)

That has been industry's understanding in the context or paragraph 88 – i.e., a subsequently modified contract, from its original terms, that allows missed or reduced payments is considered non-payment risk. The below paragraph, from the P&P Manual, clearly states that original contractual agreements which allow the financial flexibility to not make payments or is exposed to a participatory risk is non-payment risk. We believe subsequent modifications of the original terms would similarly create similar non-payment risk but the proposal inappropriately expands upon this. It is our understanding that subsequent modifications are meant to augment the below language and put one in the same place as if those terms were in the original contract. But that is in the context of not getting paid what was expected, as opposed to repayment timing. At a minimum, the P&P Manual language is conflicting or unclear.

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

Question 4: Is it appropriate to selectively tie the Subscript S concept to the definition of an NAIC Designation given that the SVO has not been able to define this over the last several years, has not been publicly identifying Subscript S securities (see proposed deleted language in paragraph 88 which delineated that role to the SVO), and for which the P&P Manual currently has conflicting definitions to what is being inferred in this definition?

For example, the following are proposed deleted paragraphs:

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

> *Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a scheduled basis (defined in the contract) is an event of default (in the case*

of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).

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

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

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

This language illustrates a situation where the insurer may not get repaid what they were expecting, as opposed to repayment timing, and the specific example includes an embedded derivative which would not meet the revised SSAP No 26R principle-based bond definition (PBBD) accounting guidance. It also defines participatory risk where the borrower by contractual definition may not get paid. We agree this would be non-payment risk, but the proposal greatly expands upon this.

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

Again, this illustration is such that missed payments are not required to be paid as opposed to repayment timing. We agree this would be non-payment risk, but the proposal greatly expands upon this.

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

There is no non-payment risk in this illustration, as there are no missed payments that are not required to be paid on a subsequent date. Instead, it is representative of long-duration credit risk. That risk may be related to an insurer's ability to pay claims vis-à-vis asset/liability matching but assessing claims paying ability (vs. assessing credit risk) has not historically been under the purview of the SVO/VOSTF.

Conclusion

In conclusion, our proposed definition would, for example, provide flexibility to consider risks such as with PIKs, if they impact the risk of repayment (positively or negatively), but does not expand the VOSTF/SVO's responsibility. Specifically, it does not attempt to assess liquidity risk (which would be contradictory to other language within the definition) in the context of an insurer's ability to pay claims. We believe that the assessment of claims paying ability extends beyond the SVO's current mandate and is addressed elsewhere within the statutory framework and would be entity specific.

We believe our proposed definition provides needed clarity and is appropriate in light of the concerns and rationale expressed in this letter. We would be interested in hearing from the VOSTF members on any concerns not captured in our proposed amended definition, or elsewhere in the statutory framework (e.g., the PBBD, the assessment of the ability of insurers to pay claims, the risk-based capital factors, etc.).

The undersigned stand ready to assist in this process and help ensure the NAIC and the assignment of risk-based capital charges continue to appropriately evolve and be refined for changes occurring elsewhere within the NAIC framework.

If you have any questions regarding this letter, please do not hesitate to contact us.

Sincerely,

Mike Monahan
ACLI

Tracey Lindsey
NASVA

John Petchler
on behalf of PPiA Board of Directors

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

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