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June 29, 2023

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

Re: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "P&P Manual" or "the Manual") to Update the Definition of an NAIC Designation in Parts One and Two of the P&P Manual

Dear Ms. Mears:

The undersigned (ACLI, PPIA, SFA, and NASVA) appreciate the opportunity to comment on the exposure referred to above that was released for comment by the Valuation of Securities Task Force (VOSTF) on May 15, 2023. We generally like to provide constructive comments on VOSTF exposures and provide support wherever possible. However, the undersigned are confused on the intent, scope and potential impact of this exposure, as it relates to the Definition of an NAIC Designation and Subscript S Non-Payment Risk. The commingling of these two issues, without any significant, robust documented rationale or transparency of the potential impact, leaves the undersigned guessing as to the impact and precludes us from providing more targeted comments.

The undersigned are concerned about the proposed expansion in scope of Securities Valuation Office (SVO) responsibilities, without transparency as to the rationale and impact of the specific proposed changes, the specific processes that will be impacted related to the proposed changes, and the issues surrounding the differentiation between individual security risk and portfolio risk. This view is substantiated by the conclusions of an extensive study commissioned by the VOSTF, following a non-transparent SVO initiative related to trust preferred securities. The capital market disruption that followed the trust preferred securities actions resulted in a congressional inquiry, and VOSTF commissioned a study from a subgroup of the Investment Analysis Working Group that among other things:

- Was part of the NAIC's transparency initiative, which was necessary to minimize future problems, and
- Focused on examining individual security risks versus portfolio risks

We support NAIC initiatives to address market innovation but believe transparency is important and historical lessons learned should not be forgotten. The report is included as Attachment A, and we will refer to both transparency and individual security risk throughout this letter.

That study concluded that credit risk is separate and distinct from multiple other identified risks, including event, liquidity, call, extension, deferral, and currency risks. In its Exhibit Three it also describes how these non-credit risks were addressed in the regulatory framework. Among those on the working group expert panel were regulators, NAIC staff and accounting, actuarial and investment professionals. Insurance industry trade associations were not included.

We understand weekly meetings (some day-long) were held beginning in January 2008 and continued at least through May. The final report was submitted in August 2008.

Ultimately, the working group recommended improvements in asset-specific disclosures and a regular reassessment of RBC factors by the Capital Adequacy Task Force (CATF), but the working group did not recommend that the scope of risks assessed as part of an NAIC designations be expanded, because many of the other defined risks were already captured in some way within the C-1 Risk Based Capital (RBC) risk framework and not related to credit risk. The findings of the study were consistent with the current language in Part One, Item 27 of the Practices & Procedures (P&P) Manual that specifically states: "NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk." This exposure seems to be a reversal of prior NAIC policy and recommendations culminating from a very thorough analysis performed by the working group.

Definition of an NAIC Designation

In addition to Subscript S Non-Payment Risk, which we will address later in our letter, the changes to the Definition of an NAIC Designation include several changes that we believe need further and transparent review. These changes include the following:

> *89. NAIC Designations reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default.*
>
> *91. NAIC Designations must also be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) and other NAIC guidance. For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.*
>
> *92. An NAIC Designation shall reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default. It will also reflect consideration to potential "tail risks" (e.g., the probability that a security's payment default will be more than three standard deviations from the mean in greater than what is shown in a normal distribution).*

Since the exposure gives no compelling rationale as to why these changes have been made, nor to their potential impact, the undersigned request additional transparency as to their impact.

Included in paragraph 89 is the statement that NAIC Designations "reflect the timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default." The undersigned have often questioned why the SVO's and Structured Securities

Group's (SSG) designation methodology considers only the likelihood of payment default, ignoring expected recovery should a security default in payment (i.e., ignoring loss given default). Industry has spoken with multiple rating agencies, all of whom take into account expected recoveries following payment default for specific types of securities (first mortgage bonds, equipment trust certificates, enhanced equipment trust certificates and speculative grade debt, to name a few) as well as considering where debt resides within an issuer's capital stack. Likewise, bank lending also takes expected recoveries into account, with most banks strongly preferring to lend on a secured basis, recognizing the importance of collateral in reducing the overall risk position of a loan. The undersigned understand that RBC charges were initially developed using a Moody's framework, and Moody's considers expected losses, including loss given default analysis—not just a probability of default framework. The report in Attachment A highlights that Moody's and S&P factor in loss given default and recoveries as well. Therefore, the undersigned would like to understand whether basing NAIC Designations/ratings on likelihood of payment default alone (giving no consideration to potential recoveries) is incongruous with how NAIC RBC charges were developed. We propose that this matter to be formally referred to the Capital Adequacy Task Force. Specifically, CATF should assess whether the proposed language is in-line with how the NAIC's risk-based capital charges were developed, and whether it changes the meaning of an NAIC designation in a way that is incongruous with CATF's intent.

The following is from paragraph 91, "*For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security."* While the undersigned believe this phrase is rather innocuous, we believe it is appropriate to formally refer this change to CATF as well. Presumably, an NAIC designation's primary purpose (not just in "many cases") is to serve as the basis for determining the appropriate risk-based capital charge. CATF should ensure that either the reference to SFRS and "Other NAIC guidance" do not change the intent of CATF for risk-based capital and/or whether "Other NAIC guidance" needs to be explicitly and transparently defined so interpretation is not in question.

Similarly, paragraph 92 includes a new concept whereby designations should consider potential "tail risks" (e.g., the probability that a security's payment default will be more than three standard deviations from the mean is greater than what is shown by a normal distribution). This is a new concept for the P&P Manual, and limited context has been provided, leaving industry to wonder how this concept would be applied in practice by NAIC staff.

1) Does it mean that NAIC staff would assign a designation, based on expected performance under tail risk outcomes, or that staff would assign a designation based on the most likely outcomes, yet somehow give consideration to tail risk events? If the latter, how would that work?
2) If a security is rated by a Credit Rating Provider (CRP), and NAIC staff does not believe that the CRP is giving sufficient consideration to tail risk outcomes (or they disagree on what the relevant tail risk scenarios are) will staff notch that CRP rating for tail risk?
3) How does analysis of tail risk differ between structured securities and issuer obligations?
4) Is the proposal for tail risk analysis as drafted consistent with how RBC factors were determined?

The addition of tail risk analysis into an NAIC Definition raises several issues that the undersigned feel must be clearly addressed.

The undersigned again propose that this matter be formally referred to CATF, to consider whether this is in line with how the NAIC's risk-based capital charges were developed, whether it changes the meaning of an NAIC designation in a way that is incongruous with CATF's intent, and/or whether it is a departure from definitions provided for agency credit ratings, who make no such references in their definitions. Ultimately, if this concept is adopted, its definition and impact should be very explicitly and transparently documented. Insurers need to understand in practice how tail risk would be evaluated—both for structured securities and for issuer obligations.

Lastly, many references to Subscript S and liquidity have been referred to within the newly proposed Definition of an NAIC Designation. Subscript S warrants a significant and separate section within our letter.

Subscript S Non-Payment Risk

Proposed Change in Scope Regarding Subscript S Authority

The exposure was presented as a technical change intended to simplify the P&P Manual. However, the undersigned believe that combining the NAIC Designation Subscript S definition in Part Two of the P&P Manual with the definition of an NAIC Designation in Part One, as drafted, effectively expands the scope of the SVO's and the SSG's authority. Part Two of the current version of the P&P Manual clearly limits the SVO's ability to assess for Subscript S risks to transactions where the SVO assigns a Designation or where the VOSTF or a regulator request that the SVO assess Subscript S risk for a particular transaction. The undersigned believe that the P&P Manual, as currently constructed, does not allow the SVO to notch ratings assigned by CRPs. This view is further supported by the fact that there are no Blanks administrative symbols in Schedule D for an NAIC Designation that combine both the "FE" and the "S" subscripts. Administrative symbols exist for "FE" and for "S" individually, but not for "FE" and "S" in combination.

The undersigned believe that the exposure could be interpreted as granting the SVO/SSG authority, not only to identify Subscript S risks, but to notch NAIC Designations accordingly—both those assigned directly by the SVO and those assigned by CRPs. The undersigned specifically reference two parts of the exposure that lead us to believe this is the practical outcome:

1) The bullet point in Part One, Item 93 was specifically modified to add the italicized phrase highlighted in red: "NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk, *though these other risks may be reflected in Other Non-Payment Risks, as described in this manual."* The additional reference to Other Non-Payment Risks specifically modifies the scope of an NAIC designation to allow for consideration of such risks.

2) Item 99, entitled "Directive to the SVO to Assign the Subscript S Symbol" was added to the Manual as part of the exposure. This provision states that: *"The VOS/TF expressly assigns to the SVO the responsibility for assessing Other Non-Payment Risk and the authority to notch NAIC Designations and assign the Subscript S Symbol, accordingly. It does so in recognition that credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes. The VOS/TF may periodically request the SVO report to it on information the SVO gathers from its review of Subscript S securities, including, for example, volume of such securities and the types of other non-payment risks."* This additional language would effectively delegate authority for assessing Other Non-

Payment Risk to the SVO and allow the SVO to notch CRP ratings for Other Non-Payment Risk if it deems appropriate. This is a departure from past practice.

The result of these two additions could potentially allow the SVO/SSG to notch securities for Other Non-Payment Risks with limited oversight from the VOSTF or from other regulatory bodies. Furthermore, the exposure is unclear under what circumstances, and to what degree, the SVO/SSG could notch securities for Other Non-payment Risks, which raises multiple questions:

1) Would notching be applied only to non-filing exempt securities?
2) If no, would notching be applied to both privately rated and publicly rated filing exempt securities?
3) How would the SVO/SSG identify and assess these risk characteristics for both privately and publicly rated filing exempt securities? For example, would all 40-year bonds (a proposed type of Subscript S security) need to be filed "as if" they were not filing exempt, so the SVO/SSG could assess and notch for Subscript S risk? (If so, this would essentially make these securities non-filing exempt.)
4) To what degree might the SVO/SSG notch, and under what circumstances might they choose to do so? Would it be a one-notch impact, a two-notch impact, or more?
5) Would the notching methodology be documented in a methodical and transparent way?

We have had multiple conversations with regulators and SVO staff on this issue over the past 12 – 18 months, and we still do not know the answers to the above questions. We have never received straightforward, transparent answers in our discussions, nor is it clear in this latest written exposure. We have yet to understand exactly what the exposure intends to accomplish and why it is necessary.

<u>Fundamental Concerns with Subscript S Proposal</u>

We understand from discussion with both the SVO and Regulators, for example, that interest deferral may not relate to individual security risk but may be information that individual regulators would like to have. For example, individual regulators may want to ensure that such securities are factoring in liquidity risk (e.g., if there is a significant concentration of securities with deferral features) in asset adequacy testing (AAT) for an individual company. Other times, Subscript S may represent non-payment risk as defined, and we will discuss this in more detail below.

For risks that are not individual security risks, but Regulators have a desire/need for further information (e.g., deferral risk for better understanding how utilized in AAT), the appropriate solution would be to bifurcate the Subscript S definition into two categories. Subscript S tags would represent Non-Payment Risk, while a new tag could be created (call it Subscript T, for example) to reflect securities with other portfolio risks, where the SVO does not alter its designation, as it is not an individual credit risk, but where additional disclosure is needed for Regulators at the individual company level. The undersigned are very open to providing more information on portfolio risks such as PIK interest, deferrals, prepayment risk, 40-year maturities, perpetual bonds, etc., and we are willing to work with Regulators and NAIC staff to determine the best way to provide such disclosure. We just do not believe that these risks represent credit risks for which the SVO/SSG should notch securities (or deem the securities non-filing exempt, as the exposure seems to suggest.)

As noted in our previous letter dated September 12, 2022, the undersigned highlight which of the Subscript S risks identified we believe to be individual security risks versus portfolio risks. Please see the

7 illustrations within paragraph 97 of the exposure and the illustrations below that highlight responses from our previous letter. For a more fulsome response see Attachment B to this letter.

#	Illustration	Represents Non-Payment Risk (Y/N?)	Additional Comments
1	Dollar-denominated obligation in non-U.S. currency (with no exchange rate)	Yes	See original response letter for proposed edits to ensure this language is not meant to construe that all foreign denominated bonds (i.e. not a dollar denominated obligation) have non-payment risk.
2	Perpetual debt that can miss payments w/ no requirement to be repaid	Yes	But this is duplicative of both 3a and 5 below, and is better captured in 5 below more holistically.
3a	Perpetual bonds	No	We note the Working Group report in Exhibit 2 states that risk of permanence is not an individual security risk but is an example of extension risk (exhibit 2). A quick query of Bloomberg shows there are approximately $200 billion of investment grade perpetual bonds, and we would like to understand the ratinale for filing these with the SVO for designations.
3b	40+ year maturities	No	But may be important for regulators to understand at a portfolio level where disclosure is desired.
4	Principal Protected Securities	Yes (?)	Note: These are already non-filing exempt and not schedule D bonds. Are these really non-payment risk or just not filing exempt?
5	Bonds without contractual events of payment default	Yes	Recommend additional clarity be provided, as the descriptor is one sentence with nine words. The undersigned are hard-pressed to find any examples of such securities within the capital markets.
6	A security that results in less payment than the orginal investment.	Yes	Important clarification language should be added so it would not capture bonds issued at a premium--see original response letter
7a	Security with PIK or deferred interest that doesn't capitalize or otherwise accrue	Yes	
7b	Security with PIK or deferred interest than can just be defered but otherwise capitalizes or accrues.	No	This is portfolio risk. The clear intent of the VOSTF commissioned report was to separate PIK interest and other payment deferral risks from credit risk and the NAIC desigation process. This is consistent with the current drafting in the P&P Manual. Further disclosure may be merited for AAT to understand cash flow deferral risks wholistically at a portfolio level.

Conclusion

The undersigned understand Regulators' interest in clarifying the definition of what an NAIC Designation represents - and we agree. However, we believe transparency surrounding the meaning and impact of any proposed changes should be afforded to industry and all interested parties. As such, the undersigned request a formal referral to CATF to elicit such an understanding. The undersigned also understand Regulators' interest in Other Non-Payment Risks and portfolio risks, and we are willing to work collaboratively with NAIC staff and regulators to help distinguish between individual security risks vs. portfolio risks. We are very willing to provide additional blanks fields and/or footnotes, if desired by Regulators, to identify these risks and provide sufficient qualitative information to help Regulators understand implications for insurance portfolios (e.g., portfolio risks such as PIK interest, deferrals, prepayment risk, 40-year maturities, perpetual bonds, etc.). However, this is a long running issue, and we still do not have answers to basic questions. We again ask for complete transparency to our questions related to Subscript S.

The undersigned believe the separation of Subscript S between part one and part two of the P&P Manual was deliberate. This makes it all the more important to provide robust and transparent answers to the questions we lay out, so that all parties understand any new authority bestowed to the SVO. For example, if all 40 - year bonds (which we do not believe represent non-payment risk) must now be filed with the SVO for NAIC Designations, then this is a significant change that should be transparent. (These bonds are not currently filed with the SVO.) Ultimately, the undersigned believe this exposure conflates portfolio risks and other non-payment risks with credit risk.

For securities that the undersigned believe truly represent non-payment risk (see table above), we could support those securities being filed with the SVO for a NAIC designation, similar to PPS. For the remaining types of securities listed in the chart above, which the undersigned do not believe represent individual security non-payment risk, but instead represent portfolio risk (e.g., PIK interest, deferral and extension risk, or 40-year bonds, perpetual bonds, etc.), we support disclosure so individual regulators can use as needed (e.g., in assessing if reflected in AAT). This would eliminate the concept of notching altogether – a concept for which there seems to be much confusion. Developing a common understanding of these issues amongst Regulators, the SVO, and all interested parties, needs to happen via a robust and transparent process. The undersigned stand ready to assist in this matter, and we welcome continued dialogue and questions.

Sincerely,

Mike Monahan	Tracey Lindsey	Michael Bright	John Petchler
ACLI	NASVA	SFA	on behalf of PPiA Board of Directors

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

American Council of Life Insurers | 101 Constitution Ave, NW, Suite 700 | Washington, DC 20001-2133

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. For more information, visit www.acli.com.

The Private Placement Investors Association ("PPiA") is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PPiA serves 66 member companies and works with regulators, NASVA, the ACLI, the American College of Investment Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace. For more information, visit www.usppia.com.

The National Association of Securities Valuation Analysts ("NASVA") is an association of insurance company representatives who interact with the NAIC Securities Valuation Office ("SVO") to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes.

The Structured Finance Association is the leading securitization trade association representing over 370 member companies from all sectors of the securitization market. Our core mission is to support a robust and liquid securitization market and help its members and public policymakers grow credit availability and the real economy in a responsible manner. SFA provides an inclusive forum for securitization professionals to collaborate and, as industry leaders, drive necessary changes, advocate for the securitization community, share best practices and innovative ideas, and offers professional development for industry members through conferences and other programs. For more information, visit www.structuredfinance.org.

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Attachment -1
Report of the Risk Subgroup of the IAWG

Memorandum

To: Invested Asset Working Group
From: Risk Subgroup of the Invested Asset Working Group
Date: August 26, 2008
Subject: Review of Investment Risks

This is the report of the Risk Subgroup of the NAIC Invested Asset Working Group (IAWG). The Subgroup was formed to evaluate all investment risks to determine which risks are individual security risks for fixed income securities and to review how those individual security risks are handled in the current NAIC regulatory framework.

The need to undertake the review of investment risks stemmed from the events that followed the hybrid security decisions taken by the NAIC in 2006. The issues were finally resolved by the adoption of the American Academy of Actuaries (AAA) report by the NAIC earlier this year. A full review of all possible investment risks by the IAWG, as part of the NAIC's transparency initiative, was necessary to minimize future problems.

To the extent that the Subgroup observed deficiencies, it would recommend improvements to the IAWG. There were no boundaries on the risks that could be considered as part of the deliberations. The Subgroup consisted of the following regulators and industry representatives:

Max McGee, Prudential, Chair of the Risk Subgroup
Chris Anderson, Anderson Insights
Bob Carcano, NAIC Securities Valuation Office (SVO)
Kevin Fry, Illinois Department of Insurance
Wally Givler, Northwestern Mutual
Trond Odegaard, Allstate
Matti Peltonen, New York Insurance Department
Ruth Sayasith, MetLife
Elaine Weiche, Connecticut Department of Insurance

Aside from the subgroup members listed above, significant input was also provided by Allen Elstein (Connecticut), Jeff Evans (SVO) and Jim Everett (New York).

Although a member of the Subgroup may be associated with a particular company or insurance department, his or her participation in the Subgroup was as an individual, in a professional capacity, rather than representing their company or state. The subgroup was composed of participants with various specialties including: regulatory, financial/capital markets, risk management, actuarial and accounting/reporting.

Risk Subgroup Process

The Subgroup began its work in late January 2008 and conducted weekly conference calls to discuss issues regarding investment risks. The calls did include other regulators from the states represented on the Subgroup, NAIC staff and the SVO. However, the Subgroup members made all decisions regarding the content of the report. All conference calls were documented and the Subgroup members approved minutes of the calls. There was a full and complete discussion of the issues during those calls.

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The focus of the Subgroup was fixed income securities only. We began the process by developing a list of all potential investment risks. Our initial list included approximately twenty risks and it swelled to almost thirty as we worked through the process. We used a very deliberate process to discuss each risk on our list. We focused on risks associated with individual securities and not portfolio risks although we did discuss portfolio risks during our deliberations.

We first discussed and arrived at a definition for each risk. Based on that definition, we determined whether a particular risk was an individual security risk. Some risks were discussed and disposed of quickly. Other risks took several calls to reach a conclusion. Ultimately, each risk discussed ended up on one of two lists (Individual Security Risk or Not an Individual Security Risk).

Any discussion of fixed income investment risks should include a discussion of interest rate risk as that risk can fundamentally alter the return of a fixed income instrument. Although interest rate risk was determined not to be an individual security risk but rather a systematic risk, we did discuss it in some detail.

Whenever possible, we considered existing definitions for the risks identified rather than creating new definitions. The definitions may have been changed slightly to reflect the insurance context. The sources used were the NAIC and the Federal Reserve System Joint subgroup on Financial Issues from June 2003 and textbooks such as The Handbook of Fixed Income Securities by Frank Fabozzi.

Discussion of Investment Risks

The Subgroup reviewed twenty-eight potential individual security risks, and through a full and detailed discussion, determined that eight of these risks were present in fixed income securities. The eight risks are credit, event, liquidity, call, extension, deferral, currency and leverage. After discussing all of the risks identified, the Subgroup agreed that there were no material additional individual security risks related to fixed income securities. We also discussed Financial Innovation, which is covered in more detail in Exhibit 4.

There are four additional attachments to this report which supplement our written report. Exhibit 1 provides a summary of the risks that were determined to be individual security risks along with a definition for each risk. Exhibit 2 is a listing of the balance of the risks covered as part of our deliberations, which were determined not to be individual security risks. Exhibit 3 is a grid that describes how each of the eight risks determined to be individual security risks are addressed in the current regulatory framework and recommendations to further improve the regulatory process. Exhibit 4 is Jeff Evans' report on how the ratings of rating agencies reflect loss and recovery given defaults as part of the ratings process.

Credit Risk

Credit risk is the risk of non-performance of contractual payment obligations on bonds, cash equivalents and other invested assets with the characteristics of fixed income instruments. As part of our discussions, we covered the history and development of C-1 (Asset Risk) in the RBC formula and how that relates to credit risk.

The American Academy of Actuaries (AAA) performed a review of default history in the early 1990's in order to develop the AVR and C-1 factors. The AAA utilized the Moody's default statistics as part of that review to classify securities into six rating categories. The study resulted in recommendations on the factors regardless of cause for default.

We also discussed whether the definition should be modified, as it does not explicitly state that there is a risk of downgrades of debt instruments which could lead to greatly reduced market values well before scheduled maturity dates or defaults. It was observed that the C-1 factors contemplated defaults (using a ten-year horizon) and that as an asset is downgraded RBC factors will increase and marking-to-market may even be required. Still, this does not address whether the possibility of downgrades should be stated explicitly in the definition. Ultimately, the Subgroup concluded that the present definition was adequate, however, following the concept that adverse developments for the investor with respect to any risk factor should be

expected to result in market price declines for the asset and as such credit risk was not materially different from other risks identified in this regard.

Our conclusion is that C-1 covers the risk of default and is synonymous with credit risk. Credit risk is an individual security risk. Defaults are cyclical and the factors used in C-1 should be reviewed by the NAIC on a periodic basis. We did determine that default experience is reflected in ratings provided by the rating agencies.

We recommend that the Capital Adequacy Task Force review the default studies periodically (at least once every five years or more frequently as circumstances dictate) to determine whether material changes have occurred. Based on that review, a more in-depth study of default experience may be warranted.

Deferral Risk

Deferral risk is the risk of the issuer's right to delay payments of interest or dividends (temporarily or indefinitely) on certain instruments. It was noted that the impact of deferral is already explicitly incorporated in rating agency credit ratings and is also covered as an element of C-1. Deferral risk is required to be disclosed in the bond characteristics codes in Schedule D.

Event Risk

Event risk is the risk of regulatory changes or other external actions or occurrences that are significant and unanticipated, and which impact the value of a security. It includes governmental actions that limit payments from borrowers that are otherwise willing and able to fulfill their obligations. Some examples of event risk are corporate restructuring, takeovers or changes in tax or accounting treatment of an investment as well as natural disasters. Actual or potential corporate restructurings and takeovers, in particular, may have an adverse impact on the holders of fixed-income securities in a number of ways. In general, the impact of an event can be immediate or gradual over time.

Event risk is not a risk that is included in the credit ratings of individual hybrid and other securities, according to papers by the SVO and Standard & Poor's. This is because it is generally believed that it is impossible to factor in predictions of surprise events, such as corporate restructurings and major changes to accounting or regulation, into the ratings of individual securities. Because the factors for AVR and RBC C-1 are intended to set levels for entire portfolios of securities, the impact of defaults caused by unexpected events is actually included in AVR and RBC, even though individual ratings do not reflect event risk. This is because the historical studies that formed the basis for AVR and RBC looked at the occurrences and consequences of all defaults regardless of cause, so if an unexpected event caused a default then that event was included in the calibration of C-1. This is consistent with the understanding that all factors that cause defaults are contemplated by AVR and C-1, and factors that do not cause defaults (such as foreign currency risk) are not included in AVR or C-1 risk factors.

Liquidity Risk

Liquidity risk is defined as the risk that an investor will not be able to buy or sell an asset into the market with the expected bid/ask spread, anticipated price continuity or sufficient depth, thus causing price realization or execution that is unfavorable or nonexistent. The Subgroup agreed that liquidity is both a portfolio level risk as well as an individual security risk. Liquidity risk could also change over time based on the occurrence of certain events that could make the security less liquid.

Liquidity risk is addressed in the Examiners Handbook as part of the risk-focused examination approach. The Subgroup believes that liquidity risk is a significant risk and recommends, at a minimum that, the NAIC Financial Analysis Handbook be reviewed and potentially strengthened to better address portfolio liquidity risk.

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Call Risk

Call risk is the risk that an issuer may elect to retire an asset, in whole or in part, when the investor would have preferred that the asset remain outstanding. Call risk and extension risk are closely related.

Call risk is currently addressed for life insurers through asset liability management, statutory cash flow testing and RBC C-3 Phase I. Call risk is required to be disclosed in the bond characteristics in Schedule D for all insurers but the details of the call provisions for a security are not readily available to state insurance regulators. Provisions should be made for facilitating access by regulators to the specific call features, possibly by including them in the SVO database project.

Extension risk

Extension risk is the risk that an issuer may elect not to retire an asset, in whole or in part, prior to its maturity date when the investor might have anticipated and might have preferred early retirement.

Extension risk is currently addressed for life insurers through asset liability management, statutory cash flow testing and RBC C-3 Phase I. Extension risk is required to be disclosed in the bond characteristics in Schedule D for all insurers. Provisions should be made for facilitating access by regulators to the specific extension features, possibly by including them in the SVO database project.

We also discussed how mortgage-backed securities are impacted by call and extension risk. In the case of mortgage-backed securities, the cash flow depends on the timing of principal repayments made by the borrowers in the pool of mortgages that serve as collateral for the security. Prepayment risk is the risk that borrowers will prepay all or part of their mortgage sooner than anticipated. Extension risk is the risk that prepayments will be slower than anticipated.

Currency Risk

Currency risk is the risk that a nondollar-denominated bond (i.e., a bond whose payments occur in a foreign currency) has uncertain U.S. dollar cash flows. The dollar cash flows are dependent on the foreign exchange rate at the time the payments are received.

Payments linked to foreign exchange rates are required to be disclosed in the bond characteristics codes in Schedule D. The Subgroup believes that currency risk is adequately disclosed in the annual statement, but recommends that the IAWG review the disclosures for potential enhancement.

Leverage Risk

Leverage risk is the risk associated with increasing the volatility of periodic payments. Using leverage, principal repayment terms also may be structured to increase their uncertainty, which increases credit risk. Security specific leverage is generally accomplished through structuring periodic payments according to formulae.

Rating agencies consider the risk of credit leveraging when assigning a rating to a security or a tranche of a structured security. Therefore, the risk of credit leveraging would be captured through the C1 (Credit Risk) component of the life RBC formula. In the situation where periodic payments (e.g. interest payments) may be leveraged, modeling of the security in C-3 Phase I of the life RBC formula would capture the impact of leveraging of periodic payments of the security in the Asset-Liability mismatch risk.
Leverage risk is required to be disclosed in the bond characteristics codes in Schedule D which identifies when the insurer can vary the amount of periodic payments.

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Other Considerations

- We also discussed the Bond Characteristics (Schedule, D Part 1, Column 5) and their development during the implementation of Provisional Exemption to enhance disclosure. Realizing that credit ratings referred only to default risk (and its costs), IAWG members sought a mechanism to flag risks other than credit risks. Disclosure of these risks (call, foreign currency *etc*.) for each individual asset was considered at the time to be an enhancement to the explicit reliance on ratings based solely on credit as the basis for AVR and C-1. The IAWG should consider expanding the Bond Characteristic codes to enhance disclosure and transparency.

- It was pointed out during our discussions that we need to be thinking about the cumulative effect of a specific risk across a number of asset classes. It could be more significant than just an individual security.

- There were also seventeen additional risks that were considered as part of our discussions. Those risks are outlined in Exhibit 2. The discussion on most of those risks was very short since the Subgroup members quickly agreed that they were not individual security risks. In some instances, the risks were already embodied in the eight risks that were deemed to be individual security risks. In many instances, we agreed that they represented legitimate risks but were not individual security risks. The details on the risks deemed not to be individual security risks are documented in Exhibit 2 (further details are contained in the minutes from the meetings which are included in the Appendix).

- We had an interesting discussion on conversion risk. If a security has a mandatory conversion provision, it is treated in RBC as if it had already converted so the risk is addressed from a solvency supervision standpoint. If the conversion is not mandatory, there is no incremental risk because the conversion is at the investor's option. We concluded that conversion risk does not warrant further attention at this time but this should be documented in our work product.

Recommendations

The Risk Subgroup recommends:

- The Capital Adequacy Task Force should review the default studies periodically (at least every five years or more frequently if circumstances dictate) to determine whether material changes have occurred. Based on that review, a more in-depth review may be warranted.
- The NAIC Financial Analysis Handbook should be reviewed and potentially strengthened to better address portfolio liquidity risk.
- The IAWG should consider expanding the current database project by the SVO, or other alternatives to address regulators concerns about additional data on call and extension characteristics of specific securities.
- The VOS Task Force should consider expanding the Bond Characteristics codes to incorporate additional needs of regulators to identify attributes of securities.
- The Subgroup believes that currency risk is adequately disclosed in the annual statement, but recommends that the IAWG review the disclosures for potential enhancement.

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Exhibit 1

Individual Security Risks

Credit risk is the risk of non-performance of contractual payment obligations on bonds, cash equivalents and other invested assets with the characteristics of fixed income instruments.

Event risk is the risk of regulatory changes or other external occurrences that are significant, unanticipated and external, which impact the value of a security.[1]

Liquidity risk is the risk that an investor will not be able to buy or sell an asset into the market with the expected bid/ask spread, anticipated price continuity or sufficient depth; thus causing price realization or execution that is unfavorable or nonexistent.

Call risk is the risk that an issuer may elect to retire an asset, in whole or in part, when the investor would have preferred that the asset remain outstanding.[2]

Extension risk is the risk that an issuer may elect not to retire an asset, in whole or in part, prior to its maturity date when the investor might have anticipated and might have preferred early retirement.

Deferral risk is the risk of the issuer's right to delay payments of interest or dividends (temporarily or indefinitely) on certain instruments.

Currency risk is the risk that a nondollar-denominated bond (i.e., a bond whose payments occur in a foreign currency) has uncertain U.S. dollar cash flows. The dollar cash flows are dependent on the foreign exchange-rate at the time the payments are received.

Leverage risk is the risk associated with increasing the volatility of periodic payments. Using leverage, principal repayment terms may be also structured to increase their uncertainty, which increases credit risk. Security specific leverage is generally accomplished through structuring periodic payments according to formulae.[3]

[1] Includes governmental actions that limit payments from borrowers that are otherwise willing and able to fulfill their obligations.

[2] In the case of mortgage-backed securities, the cash flow depends on the timing of principal payments made by the borrowers in the pool of mortgages that serve as collateral for the security. Prepayment risk is the risk that borrowers will repay all or part of their mortgage sooner than anticipated. Extension risk is the risk that prepayments will be slower than anticipated.

[3] As an example of leverage risk under this definition, Inverse Floating Rate instruments may be used to lever the risk and returns of periodic payments (*e.g.*. interest payments). Other instruments, such as Collateralized Debt Obligations, or CDOs, can be used to lever credit risk (as defined herein) and the effect of this leverage is reflected in rating agency ratings, NAIC Designations and C-1 factors.

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Exhibit 2

Risks Not Considered as Individual Security Risks

Conversion risk of a mandatory convertible security is not an individual security risk.

Systemic or systematic risk is not an individual security risk because it relates to classes of securities, securities markets or even broader market place.

Reinvestment risk is not an individual security risk but is considered a portfolio risk.

Refinancing risk is not an individual security risk and is already covered in call and extension risk.

Prepayment risk is part of call and extension risk.

Political risk is not an individual security risk and is already considered as part of event risk.

Sovereign risk is not an individual security risk and is already considered as part of event risk.

Recovery risk is not an individual security risk since it already covered in credit risk. This was confirmed in discussions with rating agencies and by reviewing their documentation.(See Exhibit 5)

Risk of permanence is not an individual security risk but is an example of extension risk.

Option risk is already addressed in other risks (call, extension and leverage).

Market risk is not an individual security risk since it is the sum of all the other individual security risks which have already been identified.

Reinsurer risk.

Counterparty risk.

Lack of accountability risk.

Yield-Curve (Maturity) risk.

Inflation risk.

Market manipulation risk.

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Security Specific Investment Risks and the Insurance Regulatory Framework

EXHIBIT 3

Risk	Manner in which addressed in the 2008 regulatory framework	Recommendations
Credit	Covered through C-1	Capital Adequacy Task Force should review the default studies periodically (at mininium every five years) to determine whether material changes have occurred. It is important to note that the default studies by their nature are backward-looking and need to incorporate low probability/high severity events (such as a depression). These studies should be reviewed periodically since financial innovation may impact future experience.
Event	Covered through C-1 in the aggregate if it results in default In other cases not addressed since it is unanticipated The balance of the risk is addressed in C-4 for life insurers.	None
Liquidity	Important at the portfolio level and how it impacts the insurance company Not explicitly addressed in current structure for RBC or reporting Companies use varied internal calculations to monitor liquidity Risk-focused exam can be a platform for examining and assessing company liquidity practices	NAIC Financial Analysis Handbook needs to be reviewd and potentially strengthed to address liquidity risk.
Call	Covered through ALM and C-3 Phase I for life insurers only. Covered through statutory cash flow testing for life insurers. Required to be disclosed in the bond characteristics codes in Schedule D.	Provisions should be made for facilitating access by regulators to the specific call features, possibly by including them in the SVO database project.
Extension	Covered through ALM and C-3 Phase I for life insurers only. Covered through statutory cash flow testing for life insurers Required to be disclosed in the bond characteristics codes in Schedule D.	Provisions should be made for facilitating access by regulators to the specific extension features, possibly by including them in the SVO database project.
Deferral	Covered through C-1, see reports from AAA and Hybrid RBC Working Group It is noted that NRSROs rate for significant deferral risk Required to be disclosed in the bond characteristics codes in Schedule D.	None
Currency	Payments linked to foreign exchanges rates are required to be disclosed in the bond characteristics codes in Schedule D.	The Subgroup believes that currency risk is adequately disclosed in the annual statement, but recommends that the IAWG review the disclosures for potential enhancement.
Leverage	Required to be disclosed in the bond characteristic codes in Schedule D and identifies where the issuer can vary the amount of periodic payments. The risk of credit leveraging is addressed in C-1.The leveraging of interest rate risk is addressed in C-3 Phase I of the life RBC formula.	None

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Exhibit 4

Financial Innovation

The members of the Subgroup considered the risks related to financial innovation (a/k/a financial engineering, financial structuring), including modeling risk, information risk, and complexity risk. Fixed income investments subject to such risks include, but are not limited to: callable/escrowable municipal bonds, municipal inverse floaters, auction rate securities (ARS), mortgage backed securities (including pass-throughs, CMOs, IOs/POs and other MBS variants), asset backed securities, and cash market and funded synthetic collateralized debt/loan obligations (CDOs/CLOs). Any security that is not a straightforward non-callable bond would be subject to some degree of the risks attendant to financial innovation. However, a true statement for the general category may not be true (in a practical sense at least) for an individual security in that category. For example, a cash market AAA CDO tranche would arguably have less risk under almost all conceivable circumstances than the underlying pool of collateral, financial engineering notwithstanding. Further, a true statement for the general category may not be true for an individual security when considered in an asset portfolio context – for example, MBS IOs (which may be used as a tool to reduce portfolio duration – arguably reducing interest rate risk). These examples begin to illustrate the challenge of a one-size-fits-all approach, or a security specific approach, to characterizing financial innovation risk.

As evidenced by the instruments listed above, financial innovation is not a new market phenomenon. Relative to non-callable fixed income instruments, financially engineered instruments generally require more sophisticated analysis (including modeling) and more information to properly characterize their expected cash flows, the risks associated with timely (either premature or belated) and complete receipt of these cash flows, and as events have recently unfolded, in some cases, their liquidity. The members of the sub-group were in general agreement that financial engineering risk is, at least conceptually, security specific. For instance, the risks presented by student loan ARS are completely different from the risks presented by funded synthetic corporate CDOs, and derive from the respective nature of the underlying collateral and the structure of the instruments. Analysis of the risk, therefore, naturally requires an understanding of the specific characteristics of the instrument in question. However, comprehensive characterization of the risks generally extends beyond instrument specifics, and for many instruments includes an underlying interest rate simulator/generator (generally monte carlo or lattice based, depending on the particulars of the instrument). Interest rate simulators are at the heart of many fixed income instrument risk analyses, and their implementation involves as much judgment and skill as the modeling of the specific instruments. In some cases, the nature of the instrument requires modeling of default correlations – a non-security specific (more accurately a cross security) parameter. These realities complicate a myopic focus on the security specific aspects of the risk in question.

There was considerable debate within the sub-group regarding whether financial innovation represents an individual security risk or an operational risk. However, there was agreement that it is a legitimate concern and should be addressed within the regulatory framework. The sub-group felt that is less important that financial innovation be characterized as an individual security risk, than it is for regulators to have a process to identify securities that are so affected, so that they can engage companies in further dialogue about how they manage the risks often attendant to these securities.

Summarizing the preceding, the general sense of the sub-group is that 1) the risks presented by financial innovation represent a legitimate concern worthy of regulatory attention, 2) while aspects of the risk are security specific, a security specific approach to addressing such risk is incomplete and otherwise problematic, and 3) a more appropriate approach to handling financial innovation risk is to regard it as a subset of operational/management risk, and to improve the regulatory review of management processes and expertise. Further, the sub-group recommends that the IAWG consider ways to make improved security information more readily available for regulator use, perhaps through the Bond Characteristics column of Schedule D.

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Exhibit 5

Recovery Ratings and Loss Given Default Assessments
How Standard & Poor's and Moody's Incorporate Recovery and Losses Following Default in Their Ratings Processes

Prepared by:

Jeffrey L. Evans, CFA
NAIC SVO
IAWG subgroup on Risks
07/24/2008

Both of the two largest NRSROs incorporate recovery analysis (S&P) or loss given default assessments (Moody's) in their below investment grade corporate ratings. Essentially, in their efforts to incorporate recovery in default, both rating agencies notch lower (usually) or higher (less frequently) from the baseline probability of default rating. Thus, the issue rating as published is a blend of the strict probability of default, combined with recovery of the investment in the event of a default.

The notching is based on the agencies' assessments of what proportion of the face value of the obligation a debt holder is likely to receive on their investment should the issuer default on its obligations. These assessments are influenced by three main factors: 1) the quality of the collateral of the issuer overall; 2) by the relative size of the claim relative to the collateral; and 3) the order of priority of claim in the capital structure that each issue represents. An issue backed by substantial collateral, that is higher in priority, will be notched higher; while one backed with little or no collateral, that it lower in priority, will be notched lower

Conceptually, this means that between two issues with the same rating (say "B+/B1" rated senior subordinated bonds of ABC and XYZ); one (XYZ) might actually be more likely than the other (ABC) to default. In default, however, expected recovery on XYZ would be higher than ABC.

The methodologies by which the two rating agencies arrive at their conclusions are very different in process, if not so greatly different in outcome. For a discussion on the agencies' respective methodologies, see S&P "Corporate Ratings Criteria 2008", available at:

http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/2,1,1,4,1204836634695.html[1]

"Probability of Default Ratings and Loss Given Default Assessments for Non-Financial Speculative-Grade Corporate Obligors in the United States and Canada" is available at:

http://www.moodys.com/cust/content/loadcontent.aspx?source=staticcontent/free%20pages/LGD/lgdadpage.htm[2]

What follows is an examination of the hypothetical case above, following the steps that end with identical ratings, but with different probabilities of default and corresponding different levels of expected recovery.

For the two issuers, ABC and XYZ, to have identical issue ratings but with different probabilities of default, they must have different baseline or enterprise level ratings. In S&P's nomenclature, this is called a Corporate Rating, or an Issuer Rating.

[1] Free registration is required. Once logged in, click "Research and Knowledge/Criteria & Methodologies/Ratings – Corporates.
[2] Free registration is required. Once logged in, this report is listed under "Reports" dated August 23, 2006.

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Moody's calls it their Corporate Family Rating. In the case of ABC, imagine that it has an Issuer rating of "BB+" from S&P and a Corporate Family Rating of "Ba1" from Moody's. XYZ, on the other hand, has an S&P issuer rating of "B" and a corporate family rating from Moody's of "B2." In this case ABC and XYZ baseline or enterprise level ratings are four notches apart, with ABC rated higher. It is interesting to note that using Moody's published historical default statistics, a "B2" rated bond has a nearly 36% likelihood of defaulting over 10 years, while for a "Ba1" rated bond the likelihood of default over 10 years is just over 10%.

Let us assume that ABC is a company that has relatively little collateral for bondholders to claim in the event of a default. ABC could be a services company that is rated on the basis of its cash flow. Let us further assume that there is a substantial amount of debt on ABC's balance sheet that is senior to the issue in question. Should ABC default, what little collateral there is would be claimed by the senior debt holders, leaving nothing for the issue we are looking at. In this case, both S&P and Moody's might notch ABC's senior subordinated debt *lower* by two steps, to "BB-/Ba3."

With the other issuer, assume that XYZ, although lower rated, has good collateral for the bondholders. Perhaps it is a company with more leverage, or a weaker competitive position, but one that has valuable and marketable assets for collateral. XYZ might be an independent oil producer with proven oil reserves in its portfolio, reserves that would fetch a good price from another buyer. Let us further assume that XYZ has very little debt on its balance sheet that is senior to the issue in question. Were XYZ to default, the senior subordinated investors could expect to receive the full face value of their investment, because the collateral coverage is so strong. In this case, both agencies might notch XYZ's senior subordinated debt *higher* by two steps, to "BB-/Ba3."

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September 12, 2022

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

Re: Amendment to the P&P Manual to Update the Definition of Other Non-Payment Risk Assigned a Subscript "S"

Dear Ms. Mears,

The undersigned (ACLI, PPiA, NASVA) appreciate the opportunity to comment on the exposure, referred to above, that was released for comment by the Valuation of Securities Task Force (VOSTF) at the NAIC Summer National Meeting.

The undersigned are also appreciative that the Securities Valuation Office (SVO) was willing to work with industry to try and gain a mutual understanding of non-payment risk to the new additions and existing language being proposed, including with PPNs, and significant progress was made. However, we are still concerned with various aspects of the proposal.

Relevant Background Information

The proposal references at least three parts (parts one, two and three) of the P&P Manual. The proposal itself proposes changes to part two but defers proposed changes to part three. Our

comments reflect the assumption that the de facto second phase of this proposal would be to make subscript S securities non-filing exempt. This is an important assumption that is reflected in our comments.

Further, our comments reflect the fact that the P&P Manual at times can be very difficult to navigate due to its complexity and often conflicting guidance. For example, this was illustrated by the second item, of the July 28, 2022 summer national meeting agenda, where the SVO itself highlighted several conflicting statements in relation to clarifying its role in relation to Interpreting Accounting and Reporting. This proposal was ultimately adopted with the support of industry. Our comments here attempt to simplify and avoid unproductive debate on potentially conflicting or ambiguous language in the P&P Manual.

In simple terms, we understand Subscript S to mean any security that has non-payment risk in addition to the credit risk of the issuer. We believe this provides a more readily available foundation rather than trying to include the many references and inferences within the P&P Manual that may be confusing or contradictory.

More specifically, we note that the P&P Manual (paragraph 37) notes that an NAIC designation reflects credit risk does but does not measure prepayment, extension, or liquidity risk. Paragraph 37 is the foundational language in the P&P Manual describing what an NAIC Designation measures.

Eight Proposed Illustrations of Subscript S Non-Payment Risk

Our approach is to offer perspective on each of the eight illustrations being proposed and address where we believe there is (or isn't) non-payment risk that should ultimately cause a security to no longer be filing exempt and/or where the language is ambiguous or unclear.

Illustration 1 – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield 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.~~

Non-payment risk – We agree that this illustration highlights a security that has non-payment risk. This describes a dollar denominated bond whereby the payment at maturity, is denominated in US dollars, whereby repayment may not be repaid in full because it depends upon an exchange rate.

However, we suggest the highlighted (i.e., shown with a strike through) language be removed for clarity purposes – i.e., so as to ensure that language is not meant to construe that all foreign denominated bonds (i.e., not a dollar denominated obligation) have non-payment risk. Foreign denominated bonds are funded in a foreign currency with the expectation that both interest and principal will be received in the same foreign currency. Further, the majority of such insurance company investments are hedged for foreign currency risk. Therefore, any notching by the SVO would be inappropriate.

Illustration 2 – 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.

Non-payment risk – We agree that this illustration represents a security that has non-payment risk. Essentially, by allowing a perpetual security that can miss scheduled interest or dividend payments that are not required to be paid on a subsequent date, such a security could be construed as permanent equity-like capital and would not meet the requirement of a bond for NAIC purposes.

Illustration 3 – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity date (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.

No Non-Payment Risk – This illustration appears to address two distinct items:

1 - Perpetual Bonds – Perpetual bonds have contractual terms that require perpetual interest payments (e.g., a perpetuity). There is no risk beyond credit risk that needs to be assessed. The accounting for perpetual bonds is being determined by SAPWG. Where accounted for as bonds, they are required to be reported at fair value. Further, if the credit quality is affected, such credit deterioration is reflected in risk-based capital in two different ways – a lower credit rating and lower risk-based capital due a lower value through fair value accounting.

2 – Bonds with maturities equal or exceeding 40 years – 40-year bonds are quite common, including from household names (e.g., Apple and Microsoft, etc.), for which insurance companies invest. These are used, in part, to match insurance company liabilities with expected payments that are 40 years or even greater. Just recently Union Pacific Corporation issued a 50-year bond. Moreover, many insurance companies have invested in 100-year bonds from prominent universities (e.g., Yale, MIT, Tufts University, California Institute of Technology, etc.). There is no risk, other than credit risk, associated with these bonds. Notching such investments by the SVO, with no deterioration in credit risk, would potentially disincentivize insurance companies from prudent investment decisions.

Illustration 4 – A Principal Protected Security, as defined in Part Three of this Manual.

Non-Payment Risk – As illustrated in Part Three of the P&P Manual.

Illustration 5 – A security with no contractual events of payment default.

Non-Payment Risk – A security that has no contractual events of payment default (i.e., no repercussion due to a missed payment) has non-payment risk beyond the credit of the issuer.

Illustration 6 – A security with contractual terms that have the potential to result in payment of contractually promised interest and/or return of principal in an amount less than the original ~~investment~~ amount of contractually promised interest and/or principal.

Non-Payment Risk – A security that has contractual terms that have the potential to result in payment of contractually promised interest and/or return of principal in an amount less than the original amount contracted for, have risk of non-payment beyond the credit risk of the issuer. However, to ensure there is appropriate clarity, we suggest the proposed changes shown above

(e.g., proposed changes shown with strike-through and underline) to ensure the written language would not inappropriately or unintentionally capture any security issued at a premium.

Illustration 7 – A security with deferred principal payment features that are at the option of the issuer, not including grace periods of up to 30 calendar days.

No Non-Payment Risk – A security where the issuer has the right to defer principal payment (analogous but opposite to call risk) does not have additional repayment risk beyond the credit risk of the issuer (as long as the bond accrues interest during the extension period).

Many securities have the ability to defer principal payments for a year, or even longer, and can be advantageous in a securitization because it can prevent distributions in kind to an insurer. This is advantageous because the insurer does not want distributions in kind, and also wants the issuer (a loan in an over-collateralized securitization) to have operating flexibility for the best exit strategy to best maximize returns. While it may represent some degree of liquidity risk, liquidity risk is not part of an NAIC designation, and the SVO is not suited to assess the overall liquidity risk of an insurer.

Such features can also actually reduce liquidity risk by preventing distributions in kind. It may also lower credit risk, by giving the borrowing company in the securitization the needed operating flexibility to maximize returns. Extension risk is also not part of an NAIC designation. If liquidity risk and extension risk are of concern to regulators, this is best served by requiring a disclosure on schedule D where such securities can be viewed in aggregate and in the context of the whole host of other information needed to assess the liquidity risk or extension risk related to any specific insurer. Any individual security (or group of securities) may potentially create liquidity risk for one company, but not another, depending upon their products, investments holdings, etc. so notching NAIC Designations, while beyond the purview of the SVO for liquidity risk, would also be inappropriate. If it would be of value for regulators to understand the extent a company holds securities with "extension risk" in the context of liquidity risk, disclosure on Schedule D may be a more appropriate solution.

Illustration 8 – A security with interest payment deferral feature that does not capitalize interest into principal (or does not require deferred interest to accrue at a compound rate) or permits interest deferral, that is not capitalized or compounded, for greater than twelve months or past legal maturity.

Non-payment risk – Many securities have deferral of interest features that get capitalized (payment-in-kind or PIK securities) that have the advantages as described in our response to Illustration 7 but also in situations where the securitization is in the "ramp up phase" (i.e., in the process of investing in the underlying investments) and may have temporary "liquidity issues". This is viewed as a favorable feature by insurance company investors as it actually decreases overall liquidity risk. In this instance, or where interest is deferred and compounded, insurers are more concerned about being made whole and this is factored in when making the investment. This example addresses situations where the interest is not capitalized, and we agree that this presents non-payment risk beyond that of credit risk. For the sake of clarity, we therefore proposed adding the language highlighted (underlined).

However, some have expressed concern that the proposed language was intended to not imply what our proposed change would suggest – i.e., any deferral of interest, even if capitalized, for greater than 12 months presents non-payment risk. If so, we do not agree as this appears to be addressing liquidity risk which is not part of an NAIC Designation. A counter-intuitive,

inappropriate and unintended result would be that this scopes in zero coupon corporate bonds, and even zero-coupon US Treasuries, which capitalize interest deferrals through the life of the bond.

Any individual security (or group of securities) may potentially create liquidity risk for one company, but not another, depending upon their products, investments holdings, etc. so notching NAIC Designations, while beyond the purview of the SVO for liquidity risk, would also be inappropriate. If it would be of value for regulators to understand the extent a company holds securities with "PIK" features, in the context of liquidity risk, disclosure on Schedule D may be a more appropriate solution.

Other Practical Issues

Requiring securities, that do not have non-payment risk, to be filed by the SVO for a designation (i.e., they would not be filing exempt) would also present the following two practical issues.

For the securities highlighted above with no non-payment risk, this would require the filing of these securities with the SVO with all the requisite documentation required for such a filing. In addition to the cost, such information may not be available to the investor as it was not contemplated at the time of investment.

Also, certain securities highlighted above with no non-payment risk (e.g., 40 year or greater maturity, PIK interest, extension risk) are of a nature that cannot be designated by the SVO (e.g., certain ABS) or are already designated by the SVO (e.g., CMBS/RMBS).

In conclusion, it is very important that any language related to Subscript S, with the expectation that such securities will eventually need to be filed with the SVO, be very clearly articulated and truly represent non-payment risk. Further, if regulators would benefit from better understanding the extent to which insurers hold securities with risks (e.g., liquidity risk, extension risk, or long maturities, etc.) which do not reflect non-payment risk, we believe disclosure of these risks on Schedule D would better assist regulators assessing such risks holistically. As Schedule D reporting is currently being revamped by SAPWG, the timing for such a solution is perfect.

*****

We stand ready to assist regulators and staff with regards to this proposal. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey
Tracey Lindsey
NASVA

John Petchler

John Petchler
on behalf of PPiA
Board of Director