



MEMORANDUM

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group
Marc Perlman, Investment Counsel, NAIC Securities Valuation Office

DATE: January 27, 2020

RE: Updated - Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Update the Definition and Instructions for Principal Protected Notes

-
1. **Summary** –The Task Force on the Oct. 31 call directed NAIC staff to work with industry on the definition for Principal Protected Securities. NAIC staff reported at the Fall National Meeting that it had met with industry representatives on Dec. 3, Nov. 22, Nov. 15 and Nov. 8. The attached updated amendment reflects the discussions to date and staff’s recommendation for a definition of this security; including, expanding this to a new P&P Manual section that provides examples. The update is consistent with the general framework that was outlined at the Fall National Meeting.
 2. **Recommendation** – NAIC staff recommends exposing this updated amendment for comment (new text is identified in red).

PART ONE
POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK
FORCE

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

PRINCIPAL PROTECTED NOTES

Defined

115. Principal Protected Notes (PPNs) are a type of security that repackages one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s) but for which the repackaged security generates potential additional returns as described in the detail criteria for PPNs, along with examples, in Part Three of this Manual.

Intent

116. Transactions meeting the criteria of a PPN as defined this Manual may possess Other Non-Payment Risks and must be submitted to the SVO for review under its Subscript S authority.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

**PROCEDURE APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL)
RATING SECURITIES**

FE SECURITIES

Filing Exemption

3. Bonds, within the scope of SSAP No. 26R and SSAP No. 43R (excluding RMBS and CMBS subject to financial modeling) and Preferred Stock within scope of SSAP No. 32, that have been assigned an Eligible NAIC CRP Rating, as described in this Manual, are exempt from filing with the SVO (FE securities) with the exception of Bonds and or Preferred Stock explicitly excluded below.

Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:

...

- **Principal Protected Notes (PPN)** - Transactions meeting the criteria of a PPN as specified in this Manual may possess Other Non-Payment Risks and must be submitted to the SVO for review under its Subscript S authority.

...

PRINCIPAL PROTECTED NOTES

Definition

324. Principal Protected Notes (PPNs) are a type of security that repackages one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s) (including principal and, if applicable, interest, make whole payments and fees thereon) that if purchased by an insurance company on a stand-alone basis would be eligible for Filing Exemption, but for which:

(i)

a. the repackaged security structure enables potential returns from the underlying investments in addition to the contractually promised cash flows paid to such repackaged security according to a fixed schedule;

OR

b. the contractual interest rate paid by the PPN is zero, below market or, in any case, equal to or below the comparable risk-free rate;

AND

(ii) the insurer would obtain a more favorable Risk Based Capital charge or regulatory treatment for the PPN through Filing Exemption than it would were it to separately file the underlying investments in accordance with the policies in this Manual.

Exclusions

325. For the avoidance of doubt, PPNs shall not include defeased or pre-refunded securities which have separate instructions in this Manual; broadly syndicated securitizations, such as collateralized loan obligations (CLOs) (including middle market CLOs) and asset backed securities (ABS), except as described in the examples in this section; or CLO or ABS issuances held for purposes of risk retention as required by a governing law or regulation.

Filing Requirements

326. Investments in PPNs must be submitted to the SVO for review because they may possess Other Non-Payment Risks that the SVO must assess under its Subscript S authority. If the SVO determines in its judgement that there are not any Other Non-Payment Risks, the SVO will permit the security to benefit from Filing Exemption, if it is otherwise eligible.

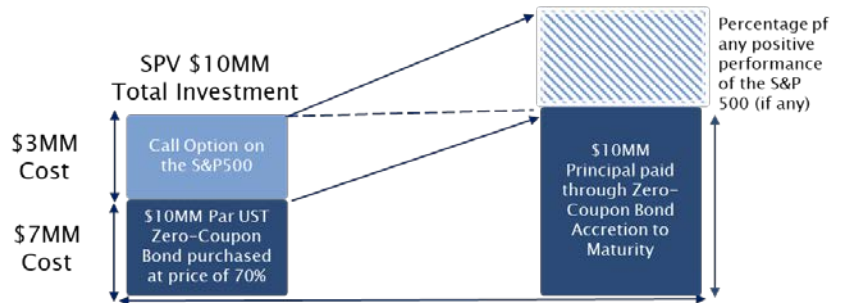
327. In addition to *Filing Process and Required Documents* outlined in Part Two of this manual, the following additional information is required for PPNs:

- Disclosure of any Subsidiary, Controlled or Affiliated relationship between the PPN or any of the underlying investments and the insurer; including, how the underlying investments were acquired.
- Prior four quarterly financial statements, if produced, trustee or collateral agent reports from the entity issuing the PPN sufficient to identify: security specific details of each underlying investment (security identifier, descriptive information, all Eligible NAIC CRP Credit Ratings (if any), par value, market value, and explanation as to how the market value was determined).

Example Transactions

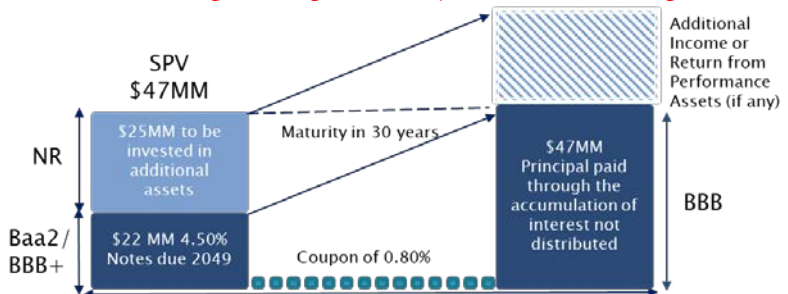
328. The following transaction examples are included for demonstrative purposes only, to highlight the core regulatory concern (that there are Other Non-payments Risks associated with PPNs beyond the contractually promised payments that may not be reflected in a CRP rating) but are not intended to encompass all possible PPN variants. Each of these examples meets the definition of a PPN.

329. In this initial example there are only two components: 1) a \$10 million par United States Treasury (UST) zero-coupon bond sold at discount (ex. \$70) from par (\$100)



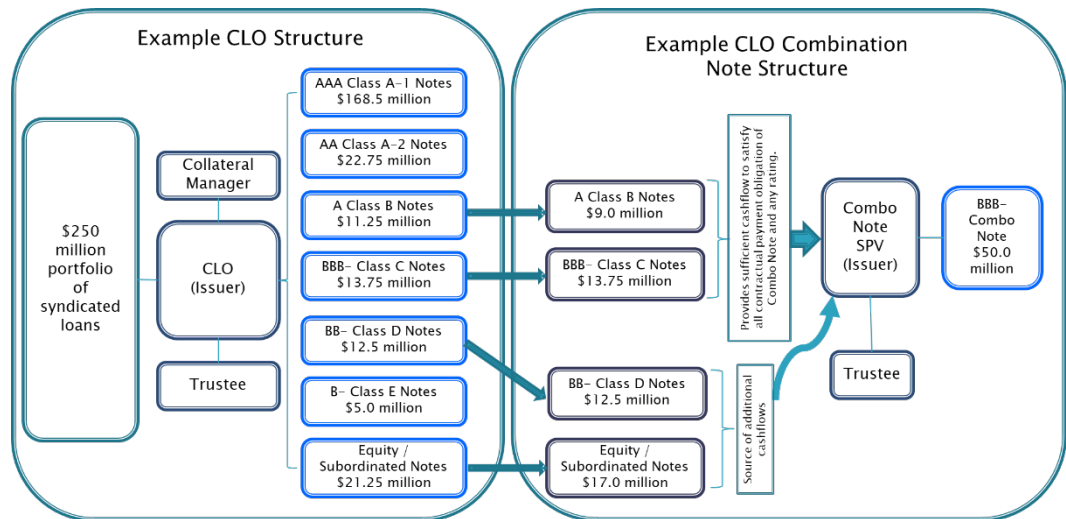
that will pay par (\$100) at maturity and 2) a return linked to any positive performance of call options on the S&P 500 Index (if the S&P 500 Index has a negative performance, investors will only receive an amount equal to their initial investment). The CRP rating would be AAA/AA+ or an NAIC 1.A, based solely on the risk of the UST security; whereas, the Weighted Average Ratings Factors (WARF) applied by the SVO would result in an NAIC 4.B when it includes the exposure to the call options on the S&P 500 Index.

330. In the second example there are multiple components: 1) a \$22 million corporate bond paying a fixed coupon (ex. 4.50%) with a stated maturity date (ex. 9/30/2049), 2) the corporate bond has two CRP ratings (Moody's Baa2, S&P



BBB+), 3) the Special Purpose Vehicle (SPV) also invests \$25 million in additional undisclosed and unrated assets, 4) the SPV pays a below market semi-annual coupon of 0.80%, 5) the excess coupon difference (4.50% - 0.80% = 3.70%) is used to accumulate into the required principal to pay at maturity, and 6) a CRP rated the PPN a BBB or NAIC 2.B. , Again, the PPN rating is based solely on the corporate bonds that represent less than 50% of the total investment in this example, whereas, the WARF methodology would result in an NAIC 4.C when the exposure to all of the underlying investments are included.

331. The third example is a repackaging of collateralized loan obligation (CLO) notes into a CLO Combination Note (Combo Note). The initial CLO holds \$250 million of syndicated loans and issues \$255 million of notes (the CRP rating for each tranche is listed before the Class, ranging from AAA to B-) and Equity / Subordinated Notes. The Combo Note is formed in this example by re-packaging the Class B, C, D, and Equity / Subordinated Note tranches together. The total notional amount of all the tranches in the



Combo Note is \$52.25 million. The Combo Note raises proceeds by issuing a single \$50 million notional tranche of debt through an SPV. The cashflows from the Class B and C notes are sufficient to repay the \$50 million Combo Note principal and interest, if any; which, may constitute a reclassification of the Class B and C tranche interest to repay principal on the Combo Note. Payments from the underlying investments in the Class D and Equity / Subordinated Note tranches provide returns to the repackaged security in addition to the contractually promised cash flows according to a fixed schedule that are based upon the payments from the Class B and Class C Notes. The Combo Note receives a BBB- rating or NAIC 2.C on the notional of \$50 million based upon payments from the Class B and C tranches even though \$29.5 million or 57% of the underlying investments are rated BB- or unrated, whereas, the WARF would result in an NAIC 4.B when the exposure to all of the underlying investments are included.

From: Connie Jasper Woodroof
To: [Therriault, Charles A.](#)
Cc: [Genao-Rosado, Denise](#)
Subject: RE: VOSTF Exposures - Comments
Date: Monday, February 24, 2020 9:57:49 AM

|*|*|*|CAUTION: This email originated from outside of the organization. Do not click links or open attachments unless you recognize the sender and know the content is safe.|*|*|*

On Feb 23, 2020, at 12:14 PM, Connie Jasper Woodroof <c.jasperwoodroof@sapiens.com> wrote:

Principal Protected Notes proposal – The use of PPN to signify Principal Protected Notes is problematic. The PPN initialism is already used both in the Purposes and Procedures Manual of the NAIC Investment Analysis Office and the various editions of the Annual Statement Instructions to indicate a Private Placement Number issued by S&P and reported in the CUSIP field of various filings.

Whatever decision is made regarding the initialism, that decision should be consistently applied. In the definition section of the proposal (page 3), the first paragraph indicates using PPNs. However, the second paragraph uses only PPN (no s). On page 5 addressing filing exemption, PPN is once again used, while on page 6 the first paragraph uses PPNs. This type of inconsistency exists throughout the document.

Connie

Connie Jasper Woodroof

NAIC Liaison, Sapiens StatementPro

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Mike Monahan
Senior Director, Accounting



Tracey Lindsey
President

March 5, 2020

Mr. Kevin Fry, Chair
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Ms. Carrie Mears, Vice Chair
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Re: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update the Definition and Instructions for Principal Protected Notes (PPNs)

Dear Mr. Fry and Ms. Mears:

ACLI¹ and NASVA² (“the undersigned”) appreciate the opportunity to share our comments on the Updated Definition and Instructions for Principal Protected Notes with the Valuation of Securities Task Force (“the Task Force”). The undersigned appreciate the productive dialogue with the Securities Valuation Office (“SVO”) and Structured Securities Group (“SSG”) that has culminated in sufficiently clear guidance as to scope. We support the exposed scope guidance, as drafted, as a workable mechanism for fully addressing the pertinent analytical concern via a practical methodology. As the Task Force turns attention to the practical considerations of implementation, we solicit your continued engagement in addressing two distinct, but related, and critically important needs: sharing further insight into the key dynamics of the analytical methodology for deriving NAIC designations that will dictate the capital efficiency of such investments, and additional detail on the new administrative filing procedures.

In order to provide insurance companies the requisite insights for assessing the feasibility of allocations to PPN (and potentially other) investments as components of the broader strategies employed in the prudent management of their investment portfolios, we would like to achieve a better feel for the key dynamics and assumptions that typically drive the results of the NAIC’s Weighted Average Rating Factor (“WARF”) methodology. We understand that any general NAIC rating methodology must afford a measure of leeway for analytical discretion to address the diversity of structural features of a given investment

¹ 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. Learn more at www.acli.com.

² The **North American Securities Valuation Association** (NASVA) is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office 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. Find more information [here](#).

vehicle. However, insurance companies should understand the capital implications of investment decisions before a purchase. The above proposal contrasts the ratings of securities from the rating agencies with those of the NAIC's WARF methodology. It would be valuable if a walkthrough using the specific examples highlighted in paragraphs 329 through 331 could be provided to illustrate the key dynamics and assumptions that drive the NAIC designations resulting from the application of the WARF methodology. This may entail additional information, such as specificity of the coupon rate or return, for example, for the PPN example highlighted within paragraph 329. It could also entail further insight as to the manner in which the WARF methodology accounts for the passage of time and the attendant changes in the relative proportions of contractually promised payments covered by the underlying Filing Exemption eligible bonds versus those covered by other assets in the structures as the whole vehicle progresses towards maturity. Providing this additional information would help insurance companies make more informed decisions about risk adjusted portfolio allocations viewed through the lens of the NAIC solvency framework.

As we will have a new filing process for these securities, which will entail new administrative filing procedures for obtaining the NAIC designations, NASVA and ACLI member insurers would find it beneficial to work with the SVO to expeditiously refine and/or develop these procedures to eliminate as much as possible the uncertainties that will exist between now and year-end when such new NAIC designations will be needed, and eliminate uncertainty on-going for future investment purchases.

Please do not hesitate to contact either of us should you have any questions. Thank you.

Sincerely,



Senior Director, Accounting Policy
American Council of Life Insurers

Tracey Lindsey

President
North American Securities Valuation Association

cc: Mr. Charles Therriault, Director, SVO
Mr. Marc Perlman, Investment Counsel



March 5, 2020

Submitted electronically to ctherriault@naic.org and dgenaorosado@naic.org

Mr. Kevin Fry, Chair
 NAIC Valuation of Securities (E) Task Force
 1100 Walnut Street, Suite 1500
 Kansas City, MO 64106-2197

Ms. Carrie Mears, Vice Chair
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 1100 Walnut Street, Suite 1500
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Re: Updated - Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (“P&P Manual”) to update the Definition and Instructions for Principal Protected Notes (“PPNs”) (the “Exposure”)

Dear Mr. Fry and Ms. Mears:

We appreciate the opportunity to comment on the NAIC Valuation of Securities Task Force (the “Task Force”) Exposure. Security Benefit Life Insurance Company (“SBL”) is a Kansas domiciled company licensed in 49 states and the District of Columbia, with approximately \$40 billion in assets under management. Over the past several years, SBL has invested in both Collateralized Loan Obligations (“CLOs”) and CLO Combo Notes, the latter of which the Exposure now proposes to add to the definition of PPNS. It appears that this change is being proposed, at least partially, as a consequence of two reports by the NAIC’s Capital Markets and Investment Analysis Office (“CMIAO”).¹ This concerns us because these reports reach conclusions based on certain assumptions from inaccurate data. This perspective is further supported by a recently published Bank of America Global Research report, included here as Appendix II. We expand on this point later in the letter.

While we continue to support the Task Force’s and the CMIAO’s overall efforts to maintain the NAIC’s credit assessment process for insurer-owned securities, including research and analysis of insurer investments, in light of the referenced CMIAO’s reports we respectfully suggest:

- that the Task Force commission a thorough, independent analysis of the expected performance of CLO Combo Notes, which would have the benefit of providing the Task Force with additional information regarding an appropriate rating methodology; and
- that the Task Force adopt a suitable transition period before any significant modifications to the existing framework would apply.

¹ “Update on Leveraged Loans,” published August 5, 2019 and “Collateralized Loan Obligations Stress Testing U.S. Insurers’ Year End 2018 Exposure,” published on December 6, 2019.



Scope of Proposed PPN Definition

The new PPN definition proposed by the Task Force is broad and would cover a wide range of assets with securitization features. However, the assets used to illustrate the scope of the new definition are not similar in kind. The first two examples provided in the Exposure are commonly known in the market as PPNs, which pair a traditional asset with what the CMIAO calls a “performance asset”. We support the CMIAO’s and Task Force’s effort to increase transparency into such performance assets in these transactions, which we believe the industry understood to be the goal of the initial memorandum on PPNs dated July 2, 2019, which the Task Force exposed in August 2019 (the “Initial Exposure”).

The third example is a Combo Note, which is significantly different than traditional PPNs. The performance of the Combo Note is based on a diversified portfolio of term financed, senior secured loans which have a transparent and proven track record, which can be analyzed by a wide range of investors on Intex, a software system utilized industry wide. Historical data on CLOs, including CLO Residual Tranches, which represent the unrated first loss 10% of a term financed CLO (“CLO equity”) exists for more than 20 years of issuance and is the subject of substantial public analysis by investment banks, hedge funds, institutional investors, asset managers, and nationally recognized statistical rating organizations (“NRSROs”). As illustrated by CLO Residual Tranches, not every asset that would be swept into the Exposure presents the same risks that the CMIAO and Task Force identified in the Initial Exposure.

While we agree that the PPN initiative is, and should be, about transparency and appropriately measuring credit risk, we also believe the CMIAO is making a fundamentally different credit-risk based argument about CLO Combo Notes. Grouping these assets together solely because they contain some common structural features is, in our opinion, unnecessary to preserve the CMIAO’s and Task Force’s original goal of reviewing PPN structures for transparency and investment suitability.

Independent Analysis and Rating Methodology

We and other market participants are concerned (details are included in Appendices I and II included with this letter), that the CMIAO reports utilize inappropriate data, analysis, and assumptions. In short, we and others believe that:

- The analyses use old data, dating to the 1970s, and excludes more recent data (since 2009) available from both S&P and Moody’s. Furthermore, more recent post-crisis CLO structures are stronger than those that existed prior to the most recent Global Financial Crisis from which much of the data is drawn.
- The analyses use a “cohort” rating analysis for default assumptions rather than using the more appropriate life-to-date since issuance analysis.

- The stress analysis on senior secured loans is extreme and uses recovery assumptions over unrealistic extended periods that reflect unsecured bank debt recovery rates rather than much more relevant secured bank debt recovery rates, even though first lien secured bank debt comprises over 90% of the assets underlying CLOs.²
- The CMIAO's claim of high losses in CLO Combo Notes is based on stress scenarios that are not disclosed.
- The analysis gives no credit to the active management of CLOs, which has allowed CLOs to experience meaningfully lower loan defaults in comparison to the broader market, as well as allowed collateral managers to increase par value during volatile market periods.
- CLO Combo Notes provide additional investor protections *vis-a-vis* holding only the underlying CLO debt tranches, such as the ability to refinance, reset, or call the CLO structure and work closely with CLO managers on structures. Each SBL CLO Combo Note includes tranches from only a single CLO issuer.

We understand the concern that different capital requirements might apply if the underlying components of a CLO Combo Note were held directly. However, we believe the NRSRO ratings more appropriately reflect the credit quality of CLO Combo Notes as opposed to a Weighted Average Rating Factor (“WARF”) methodology, which the CMIAO has suggested it might use. In addition to the demonstrable historical and expected performance of CLO Combo Notes, we also believe in the appropriateness of the NRSRO CLO Combo Note ratings because rating agencies rate underlying CLO tranches much more conservatively than the actual default experience would imply. For example, ‘Baa’ to ‘B’ CLO tranches should be rated ‘A’ based upon actual life-to-date impairments, as further detailed in Appendix I.

Accordingly, we believe that CLO Combo Notes should not be included within the definition of PPNs and should remain exempt from filing. However, if these instruments are to be included, then the methodology used to rate CLO Combo Notes should be fully and thoroughly vetted based on appropriate empirical data, more realistic assumptions, and finer analysis.

We believe independent expert analysis would provide the Task Force with, among other things, a necessary additional resource on the transparency of the CLO market, the credit risk and rating methodology of CLOs and CLO Combo Notes, and the manner in which CLOs and CLO Combo

² The severity of the stress testing assumes an economic environment far worse than the most recent Global Financial Crisis, in terms of the degree of economic disaster, and assumes the same extremely stressed recovery rate for 10 years. According to Chris Flanagan, the author of the BofA Global Research report included in Attachment of Appendix II, “[a] stress test is always useful but if stresses are nowhere in the realm of reality anything can break down.” Indeed, in the extremely unlikely event that the assumed economic environment became reality, we believe many unsecured investment grade corporate bonds would suffer massive, near total losses as well.


Notes are structured and function. This analysis could be conducted in a short period of time and we would be willing to fund it. Further, we would be happy to share our analysis on CLO's to offer what we believe will be an alternative view of the credit risk of the investments relative to what is currently being presented to the Task Force.

Transition Period

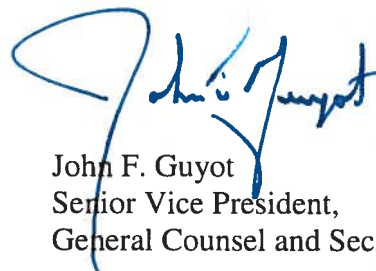
Although an effective date for the change has not yet been specified, we understand that, in the event CLO Combo Notes are ultimately included within the scope of the PPN definition, December 31, 2020 is a potential effective date. At a minimum, companies that have lawfully accumulated CLO Combo Note holdings should be afforded at least another year to provide for a reasonable transition period. Although the CLO market is approximately \$700 billion, transparent and deeply liquid, large volume sales in a quicker than typical transition timeframe may result in unfair losses to companies who have long relied on the current regulatory capital rules.

In summary, we thank you for your efforts and attention to our concerns regarding this important matter. We remain committed to working with you to develop an appropriate way to satisfy regulatory objectives regarding CLO Combo Notes and your belief that the NRSRO ratings do not adequately reflect the appropriate level of risk. We would welcome and opportunity to meet with and present our analysis on CLO's to the Task Force in person, which we believe would provide an alternative view of the credit risk of the investments.

Sincerely,



Joseph W. Wittrock, CFA
Senior Vice President and
Chief Investment Officer



John F. Guyot
Senior Vice President,
General Counsel and Secretary



Appendix I

1. CLO Performance (August CMIAO Report)

Summary

- The CMIAO published a report titled “Update on Leveraged Loans”, dated August 5, 2019
- The report states that “Historically, CLOs have been one of the best performing structured finance assets. Moreover, CLOs have also performed better at the Aaa-A levels than corporates.” However, it also raises concerns that “If during the next recession leveraged loan default at a higher rate and experience lower recoveries, CLOs will also underperform compared to historical levels.”
- In particular, the report refers to a 12.2% impairment on CLO BBB tranches and a 31.3% impairment on CLO BB tranches. CMIAO uses the below table in its report:

Rating	CLO impairment ⁽¹⁾	CDO ex-CLO impairment ⁽¹⁾	Structured Finance impairment ⁽¹⁾	Corporate Default Rate ⁽²⁾
Aaa	0%	34.8%	14.9%	0.2%
Aa	0%	50.6%	32.1%	1.0%
A	0.1%	56.5%	46.6%	3.0%
Baa	12.2%	65.5%	59.0%	4.2%
Ba	31.3%	68.7%	59.4%	19.3%

- The report highlights historical performance of CLOs versus other asset classes (CDOs, structured finance, and corporates), which we believe raises a number of questions regarding the chosen data set, including:
 - Ⓐ Time period covered in the report
 - Ⓑ Use of a cohort impairment rate versus long-term default statistic based on original issuance ratings

- A** The report used performance data for period 1993-2013 published in a September 2014 Moody’s report⁽¹⁾
- The analyses use old data, dating to the 1970s, and excludes more recent data (since 2009) available from both S&P and Moody’s.⁽²⁾
 - Moody’s itself uses its more recent report (for the period 1993-2018) when talking about CLO credit risk, which captures the most recent five years of data and the performance of “post-crisis” structures that have been in place since the financial crisis of 2008
 - **All of the defaults on Moody’s rated CLO tranches occurred in transactions issued before the financial crisis**
 - Methodologies for all agencies were revised again after the financial crisis of 2008 and **“post-crisis” CLO structures now contain no unsecured bonds, or structured finance securities, and a smaller percentage of non-first-lien senior secured loans than previously allowed**
 - **“Post-crisis” structures have more subordination with credit support effectively improving by one rating level since the crisis**
 - As an example, below is a comparison of certain concentration limitations of two Ares-managed CLOs issued pre-crisis versus post-crisis, as well as a table showing the improvement in credit enhancement levels between “pre-crisis” and “post-crisis” CLOs

Ares Concentration Limitations	Pre-Crisis	Post-Crisis	Credit Support ⁽³⁾		
Deal	Ares X	Ares XLVI	Original		
Closing Date	Sept 2005	Jan 2018	Rating	Pre-Crisis	Post-Crisis
Senior Secured Loans	Min 80%	Min 96%	AAA	25.0%	35.1%
Senior Unsecured and Subordinated Debt Securities	Max 10%	Max 0%	AA	18.6%	23.6%
Structured Finance Securities	Max 5%	Max 0%	A	12.8%	17.3%
Synthetic Securities	Max 20%	Max 0%	BBB	8.1%	11.9%
Finance Leases	Max 5%	Max 0%	BB	5.6%	7.8%

(1) Moody’s Default & Loss Rates of Structured Finance Securities: 1993-2013, dated September 30, 2014, (https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBS_SF380976)

(2) Moody’s Impairment and Loss Rates of Global CLO: 1993-2018, dated May 17, 2019, (https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBS_1164579)

(3) Wells Fargo Securities “FAQ on CLOs and Leveraged Loans”, dated January 31, 2019. Credit support is defined as the amount of capital below a given tranche in the transaction

Analysis on Cohort vs. Original Rating

- B** The numbers used to represent CLO impairment are from “cohort rating” analysis by Moody’s, which is a more common performance measure for corporates
- Cohort-level cumulative impairment rates are calculated based on pools of CLO tranches with cohort ratings as of certain dates
 - If on the next cohort formation date, the rating of a CLO tranche has migrated to a different rating category, the CLO tranche will be moved to a new cohort for the following cohort formation dates (i.e. an ‘A’ tranche that is downgraded to ‘Baa’ will be removed from the ‘A’ pool, and added to the ‘Baa’ pool). Thus, cohort analysis does not track rated issuances but shifting pools of assets that may change month over month and year over year
 - There are multiple drawbacks to analyzing CLO performance based on cohort rating
 - **Analysis based on cohort rating may lead to higher impairment rates due to adverse selection**, as the non-defaults/performing tranches tend to prepay early, leaving the “weaker” tranches outstanding in the pool, as opposed to corporates, where better-performing names tend to stay outstanding longer
 - A CLO tranche may be included in multiple cohorts when calculating the cumulative impairment rate. The analysis ignores original rating of the bond and time since issuance
 - The pool of assets formed on a cohort formation date may include tranches that are more seasoned than the impairment time horizon (i.e. a 10-year cumulative impairment rate may include a CLO tranche that is outstanding for over 10 years)
 - **Small cohort size may also reduce the accuracy of the analysis**
 - Cohort rating analysis may be more useful in measuring performance for rating actions (upgrades or downgrades), but **does not accurately capture the long term performance on all tranches issued at a certain rating category**
 - Cumulative impairment rates based on original rating is a better measure for CLO investments over a longer horizon, as it is a more “pure” measure
 - This approach measures the performance of every CLO tranche only once from the time of original issuance

Analysis on Cohort vs Original Rating (cont'd.)

- Moody's also publishes a long-term default statistic based on original issuance ratings (in particular, the life-to-date impairment rate), which is a more logical number to assess long-term credit risk.⁽¹⁾ S&P has similar statistics
 - Impairment rates⁽²⁾ computed based on original rating would retain all tranches issued with such original rating in the data set, which more accurately captures the performance of each CLO tranche since issuance
 - These long-term numbers prove that **CLOs are in fact more conservatively rated, given historical default/loss performance, than any other credit asset class**

10-Year Cumulative Impairment Rates by Original Rating (Period 1993 - 2018)						
Rating	CLO	CDO ex-CLO	US ABS	US CMBS	US RMBS	Structured Finance
Aaa	0.0%	39.1%	1.6%	4.8%	34.3%	26.0%
Aa	0.0%	48.2%	7.3%	18.3%	54.9%	39.7%
A	0.1%	53.1%	8.8%	24.1%	72.2%	46.4%
Baa	2.3%	62.4%	18.7%	31.8%	85.5%	60.8%
Ba	5.5%	60.7%	40.4%	51.6%	87.7%	57.4%

Life-to-Date Cumulative Impairment Rates by Original Rating (Period 1993 - 2018)						
Rating	CLO	CDO ex-CLO	US ABS	US CMBS	US RMBS	Structured Finance
Aaa	0.0%	31.0%	0.7%	2.3%	22.6%	14.7%
Aa	0.0%	37.8%	4.2%	12.6%	51.5%	31.5%
A	0.0%	41.0%	4.4%	19.5%	67.7%	35.3%
Baa	1.2%	48.3%	6.9%	24.1%	78.4%	45.6%
Ba	2.2%	44.9%	16.1%	46.5%	76.7%	39.2%

(1) Moody's Impairment and Loss Rates of Structured Finance Securities: 1993-2018 – Excel Supplement, dated May 16, 2019 (https://www.moody.com/research/Impairment-and-loss-rates-of-structured-finance-securities-1993-2018--PBS_1174732)

(2) Moody's defines impairment as, "A security is impaired when investors receive — or expect to receive with near certainty — less value than would be expected if the obligor were not experiencing financial distress or otherwise prevented from making payments by a third party"

S&P CLO Performance

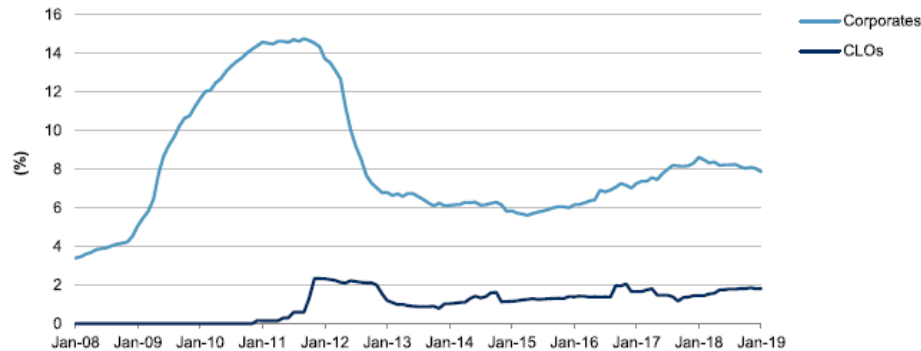
- S&P published a report ⁽¹⁾ on CLO performance in January 2014, that provided CLO default and loss data on all S&P-rated U.S. CLO tranches over a 20-year period
 - The data set shows that CLOs have resilient performance over the long-term, with historical defaults and losses at very low levels. Furthermore, all S&P-rated defaults occurred on tranches issued before the financial crisis

U.S. CLO Ratings 1994 - 2013: Defaults And Losses				
Original rating	Total tranches ⁽ⁱ⁾	Defaulted tranches	Default rate [§]	Loss rate [†]
AAA	1,992	0	0.00%	0.00%
AA	1,005	0	0.00%	0.00%
A	1,119	5	0.45%	0.08%
BBB	1,069	3	0.28%	0.21%
BB	841	14	1.66%	0.78%
B	115	3	2.61%	1.13%
Total	6,141	25	0.41%	0.04%

⁽ⁱ⁾Includes all U.S. cash flow CLO tranches ever rated as of year-end 2013. [§]Default rate = number of ratings that had ratings lowered to D/total number of ratings. [†]Loss Rate = sum of losses divided by sum of issuance amounts; market values from trustee reports used to estimate tranche losses when necessary; tranches without available loss data excluded. CLO--Collateralized loan obligation.

- When compared to corporates, another S&P report ⁽²⁾ (dated June 2019) showed that the speculative-grade three-year trailing default rates (before recoveries) for CLOs have been much lower

Global Speculative-Grade Three-Year Trailing Default Rates
CLOs versus corporates



Source: S&P Global Fixed Income Research.

(1) S&P Twenty Years Strong: A Look Back at US CLO Ratings Performance from 1994 through 2013, dated January 31, 2014 (https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/8447971)

(2) S&P 2018 Annual Global Leveraged Loan CLO Default And Rating Transition Study, dated June 19, 2019 (https://www.spglobal.com/_media/documents/2018-annual-global-leveraged-loan-clo-default-and-rating-transition.pdf)

CLO Performance Measures

- The correct reference for long-term credit risk in Baa CLO bonds are the 10-year horizon numbers and Life-to-Date numbers based on original ratings, for CLOs issued between 1993 and 2018
- The CMIAO report used an impairment assumption that is inappropriate and 10x the actual risk experience for CLOs, misrepresenting the actual credit experience of these products and their loss performance by rating
- This seems odd when the CMIAO itself refers to CLOs as having “sound structural features”⁽¹⁾
- Independent analysis and further deliberation is warranted

Data Period	Moody's				Life-to-Date	S&P
	10-Year Horizon		Life-to-Date			Life-to-Date
	1993-2013	1993-2018	1993-2013	1993-2018	1993-2018	1994-2013
	CLO	CLO	CLO	CLO	CLO	
	Impairment	Impairment	Impairment	Impairment	Impairment	
Rating	(Cohort ⁽²⁾ Rating) ^(B)	(Cohort Rating)	(Original Rating) ⁽²⁾	(Original Rating) ⁽³⁾ ^(B)	(Original Rating) ⁽³⁾	Default Rate ⁽⁴⁾
Aaa	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Aa	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
A	0.1%	0.0%	0.2%	0.1%	0.0%	0.5%
Baa	12.2%	5.3%	4.6%	2.3%	1.2%	0.3%
Ba	31.3%	13.1%	17.6%	5.5%	2.2%	1.7%

CMIAO Impairment

Moody's Long Term Impairment

S&P Long Term Default

(1) Executive Summary of “Collateralized Loan Obligations (CLOs) Primer”, dated August 21, 2018, by Jennifer Johnson

(2) Moody's Default & Loss Rates of Structured Finance Securities: 1993-2013, dated September 30, 2014, (https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBS_SF380976)

(3) Moody's Impairment and Loss Rates of Global CLO: 1993-2018, dated May 17, 2019, (https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBS_1164579)

(4) S&P Twenty Years Strong: A Look Back at US CLO Ratings Performance from 1994 through 2013, dated January 31, 2014 (https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceid/8447971)

2. CLO Stress Testing (December CMIAO Report)

- In December of 2019, the CMIAO published a paper⁽¹⁾ detailing the results of a series of stress tests on CLOs owned by U.S. insurance companies
- In the report, the CMIAO uses default data to calculate its own default vector, which overstates defaults by 3-4 percentage points compared to the Moody's published vector in both shorter and longer time horizons
- In two of the stress scenarios, the CMIAO uses an unsecured recovery rate that ignores the senior secured nature of the collateral in CLO pools
- CMIAO claims to see 28-30% "losses to principal" in combo notes across the three stress scenarios without disclosing its sample set, methodology, or calculations

(1) "Collateralized Loan Obligations – Stress Testing U.S. Insurers' Year-End 2018 Exposure", dated December 6, 2019, by Azar Abramov, Jean-Baptiste Carelus, Jennifer Johnson, Eric Kolchinsky, Hankook Lee, and Elizabeth Muroski

- The analysis included three scenarios with various assumptions
 - 1) SCENARIO (A)
 - Default: historical default vector
 - Recovery: first lien bank loan recovery rate (64%)
 - 2) SCENARIO (B)
 - Default: historical default vector
 - Recovery: senior unsecured bank loan recovery rate (40%)
 - 3) SCENARIO (C)
 - Default: historical default vector + 1 standard deviation
 - Recovery: senior unsecured bank loan recovery rate (40%)

- The stress testing was conducted on \$95.9B of “normal” tranches and \$1B of “atypical” tranches (i.e. combo notes)

- The analysis invites a number of questions and concerns
 - 1) the default and recovery assumptions
 - 2) the sample set used in the analysis
 - 3) the methodology for computing principal loss
 - 4) the conclusion of the analysis

Stress Testing Methodology: Default Assumptions

- The historical corporate default vector used in the CMIAO stress analysis is for the period 1970-2009. CMIAO determines the cumulative default vector by recalculating an existing vector found in Exhibit 44 of the Moody's Annual Default Study⁽²⁾ in order to capture an earlier data period, and cut off data within a 10-year time horizon (even though many corporates, like most senior secured loans, have shorter than 10-year lives)
- The below table is the default vector generated by CMIAO for the period 1970-2009 used in Scenarios (A) and (B) of the CMIAO analysis⁽¹⁾

1

CMIAO Cumulative Default (1970-2009)										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	2.7%	6.7%	10.9%	14.7%	18.5%	21.9%	25.3%	28.2%	30.8%	32.9%
B2	4.0%	9.8%	15.1%	19.7%	23.4%	26.8%	29.7%	32.1%	34.3%	36.4%
B3	6.5%	13.6%	20.2%	25.7%	30.4%	34.4%	37.9%	40.9%	43.5%	45.5%

- The methodology that CMIAO used to generate the cumulative default vector differs from Moody's approach when it calculates its published vector. CMIAO uses a simple weighted average method to calculate its vectors, while Moody's uses a more comprehensive approach which relies on marginal default rates
- CMIAO's decision to capture the period beginning in 1970 is not the best representation of historical default statistics. Moody's intentionally chooses to publish its weighted average cumulative default vectors beginning in 1983 as the periods before that have few samples, and 1983 was the first year Moody's created sub-notches for its ratings categories (*i.e.*, broke the 'B' rating into 'B1', 'B2', and 'B3')

(1) Moody's Annual default study: Defaults will rise modestly in 2019 amid higher volatility, dated February 1, 2019 (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1156859)

Stress Testing Methodology: Default Assumptions (con't.d)

- We regenerated the cumulative default vectors for the 1983-2018 period using the methodology described by the CMIAO stress report and find the approach results in a higher default vector than the one published by Moody's
- Below is a more recent default vector for the 'B' rating category published by Moody's that captures the more recent period 1983-2018⁽²⁾

2

Moody's Cumulative Default (1983-2018)										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	2.0%	5.3%	8.9%	12.4%	16.0%	19.3%	22.5%	25.3%	27.7%	29.7%
B2	3.0%	7.7%	12.4%	16.7%	20.3%	23.6%	26.4%	28.7%	30.9%	32.9%
B3	4.9%	10.7%	16.6%	21.7%	26.2%	30.3%	33.7%	36.7%	39.1%	41.1%

- We recalculated the 1983-2018 default vectors using CMIAO's methodology:

3

CMIAO Cumulative Default (1983 - 2018)										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	2.0%	5.2%	8.9%	12.6%	16.4%	20.0%	23.6%	27.0%	30.3%	33.1%
B2	3.0%	7.6%	12.4%	16.9%	20.7%	24.4%	27.7%	30.7%	33.7%	36.6%
B3	5.0%	10.5%	16.6%	22.0%	26.8%	31.4%	35.4%	39.2%	42.7%	45.7%

- CMIAO's methodology overstates the vectors by as much as 4.6 percentage points towards the longer time horizons:

3 - 2

CMIAO Cumulative Default versus Moody's Cumulative Default (1983-2018)										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	0.0%	-0.1%	0.0%	0.2%	0.3%	0.7%	1.1%	1.8%	2.5%	3.3%
B2	0.0%	-0.1%	0.0%	0.2%	0.4%	0.9%	1.3%	2.0%	2.8%	3.7%
B3	0.1%	-0.2%	0.0%	0.3%	0.6%	1.1%	1.7%	2.5%	3.6%	4.6%

- The combined impact of the earlier time period and different weighting methodology used in CMIAO's analysis overstates cumulative default rates in shorter time horizons as well

1 - 2

CMIAO Cumulative Default (1970-2009) versus Moody's Cumulative Default (1983-2018)										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	0.7%	1.4%	2.0%	2.3%	2.5%	2.6%	2.8%	2.9%	3.1%	3.2%
B2	1.0%	2.1%	2.7%	3.0%	3.1%	3.2%	3.3%	3.4%	3.4%	3.5%
B3	1.6%	2.9%	3.6%	4.0%	4.2%	4.1%	4.2%	4.2%	4.4%	4.4%

(1) Moody's Annual default study: Defaults will rise modestly in 2019 amid higher volatility, dated February 1, 2019 (https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1156859)

Stress Testing Methodology: Default Assumptions (cont'd.)

Below is the default vector for the 'B' rating category in Scenario (C) that includes a one standard deviation stress, used in the CMIAO analysis

4

CMIAO Cumulative Default (1970-2009) + 1 Std Dev										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	4.7%	10.7%	16.4%	21.1%	25.3%	28.8%	32.1%	35.2%	38.3%	40.9%
B2	7.1%	15.6%	22.7%	28.3%	32.0%	35.2%	37.7%	40.0%	42.7%	45.3%
B3	11.5%	21.7%	30.4%	36.8%	41.5%	45.2%	48.1%	51.1%	54.1%	56.5%

We recreated the Scenario (C) vector using the Moody's vector for the period 1983-2018 and added one standard deviation per CMIAO's methodology

5

Moody's Cumulative Default (1983 - 2018) + 1 Std Dev										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	3.9%	9.4%	14.6%	19.2%	23.4%	26.8%	30.2%	33.0%	35.6%	37.4%
B2	5.9%	13.6%	20.2%	25.7%	29.6%	32.8%	35.4%	37.5%	39.7%	41.4%
B3	9.6%	18.9%	27.1%	33.5%	38.3%	42.2%	45.2%	47.9%	50.2%	51.7%

The table below shows the difference between (1) the default vector in Scenario (C) with the one standard deviation and (2) the Moody's default vector for the period 1983-2018 with one standard deviation. The cumulative default rates are consistently overstated

4 - 5

CMIAO Cumulative Default (1970-2009) + 1 Std Dev versus Moody's Cumulative Default (1983-2018) + 1 Std Dev										
Rating\Year	1	2	3	4	5	6	7	8	9	10
B1	0.8%	1.3%	1.8%	1.9%	1.9%	2.0%	1.9%	2.2%	2.7%	3.5%
B2	1.2%	2.0%	2.5%	2.6%	2.4%	2.4%	2.3%	2.5%	3.0%	3.9%
B3	1.9%	2.8%	3.3%	3.3%	3.2%	3.0%	2.9%	3.2%	3.9%	4.8%

- The CMIAO’s base case recovery assumption is 64%, representing first lien bank loan recovery rates (based on trading prices as proxy) through multiple credit cycles, which is already much lower than recently observed first lien bank loan recoveries at ~77% (2018 weighted average recoveries)
- The additional stresses applied to Scenarios (B) and (C) using a stepdown to **unsecured** bank loan recovery rates (40%) is not reflective of the senior secured nature of first lien bank loans
 - **The stress recovery assumption of 40%, which reflects unsecured bank debt, does not reflect the reality of CLO portfolios**
 - CLOs (secured by broadly syndicated loans) have strict concentration limits that require the portfolio to contain at least 90% senior **secured first lien** bank loans
 - Senior secured bank loan is very different than unsecured bank debt. In an event of a default, senior secured lenders have control and priority claim over the underlying collateral, while unsecured lenders are not paid until the secured debt has been fully repaid
 - 40% is an implausible stress number – 64% is already quite conservative given the data – and **a further 24 percentage point downward stress on an already conservative number is meant to lead to “break” scenarios in which very high losses are output from the model, regardless of the actual definition of the asset**
- Average historical recovery rates (measured by trading prices)⁽¹⁾

Priority Position	Issuer-weighted recoveries			Volume-weighted recoveries		
	2018	2017	1983-2018	2018	2017	1983-2018
1st Lien Bank Loan	71.07%	69.19%	67.19%	77.67%	74.72%	64.07%
2nd Lien Bank Loan	54.96%	17.87%	32.27%	33.45%	30.29%	28.68%
Sr. Unsecured Bank Loan	41.93%	9.00%	45.75%	42.26%	9.00%	40.29%
1st Lien Bond	56.75%	65.91%	53.99%	68.75%	67.09%	55.23%
2nd Lien Bond	35.16%	52.75%	44.07%	43.62%	36.61%	43.74%
Sr. Unsecured Bond	48.75%	55.07%	38.15%	42.47%	41.03%	33.87%
Sr. Subordinated Bond	45.63%	38.00%	31.08%	25.60%	50.62%	26.33%
Subordinated Bond	n.a.	50.20%	31.98%	n.a.	68.34%	27.52%
Jr. Subordinated Bond	n.a.	27.17%	23.67%	n.a.	44.99%	26.78%

(1) Moody’s Annual default study: Defaults will rise modestly in 2019 amid higher volatility, dated February 1, 2019 (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1156859)

Stress Testing Methodology: Recovery Assumptions (cont'd.)

- Other rating agencies and arrangers have published similar reports stressing CLO default and recovery rates, but no other research assumes across the board recoveries at a level as low as 40%
 - S&P published a CLO stress analysis⁽¹⁾ in November 2019 in which all currently rated 'CCC' obligors default, recovering 45%, and all currently rated 'B-' obligors are downgraded to 'CCC' with price declining to 60%
 - In J.P. Morgan's breakeven analysis from fall 2018 ⁽²⁾, they stress recovery rates down to a 40-60% range to generate a principal loss in the BB tranche and note that these scenarios are severe as "at the peak of the Great Recession, the first-lien loan recovery rate dropped to average 48.33 cents ... rose to 71 cents in 2010"
 - Morgan Stanley's breakeven default rate analysis ⁽³⁾ in September 2019 uses 60% recovery rates in CLO tranche stresses
- Moody's discussed in a report⁽⁴⁾ published in August 2018 that it expect loan recoveries to decline in the next downturn due to lower subordinated debt cushion
 - However, Moody's projects a recovery of 61% for first lien bank loans in the next downturn, still much higher than the 40% **unsecured** recovery rate used in the CMIAO stress analysis
- Furthermore, since CLOs do not have any market value triggers that would require the sale of a loan upon default, ultimate recovery rates should be taken into consideration, as CLO managers can decide the best way to optimize recovery
- The table below from a Moody's report⁽⁵⁾ shows that ultimate recovery rates are often much higher than the recovery implied by trading price (on previous page) at the time of default

Priority Position	Default Year		
	2018	2017	1987-2018
Loans	85.0%	84.3%	80.3%
Senior Secured Bonds	55.0%	65.7%	62.2%
Senior Unsecured Bonds	35.5%	58.3%	47.7%
Subordinated Bonds	n.a.	62.9%	28.0%

(1) "To B- or Not to B-? A CLO Scenario Analysis in Three Acts", dated November 26, 2019, (<https://www.spglobal.com/ratings/en/research/articles/191126-clo-spotlight-to-b-or-not-to-b-a-clo-scenario-analysis-in-three-acts-11228414>)

(2) "The Late Cycle Show: ABS East CLO Feedback", dated September 28, 2018, (https://markets.jpmorgan.com/#research.article_page&action=open&doc=GPS-2787208-0)

(3) "A Default! A Default! Our Breakeven Analysis for a Default!", dated September 19, 2019, (<https://ny.matrix.ms.com/eqr/article/webapp/64c4e444-bec7-11e9-8328-83238dccc6754?ch=rpint&sch=ar>)

(4) Moody's Convergence of bonds and loans sets stage for worse recoveries in the next downturn, dated August 16, 2018 (https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1128748)

(5) Moody's Annual default study: Defaults will rise modestly in 2019 amid higher volatility, dated February 1, 2019 (https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1156859)

- The CMIAO report goes into great detail on its “stress testing” of CLOs, but its discussion on combo notes is very short and lacks detail
 - Sample set
 - The report claims to have conducted stress testing on only \$1B of combo notes, which creates a small sample bias
 - The sample set used for the analysis was undisclosed (unclear if recent or seasoned deals) and it is therefore impossible to replicate the tests
 - The compositions of the combo notes were unknown (the amount of rated tranches and CLO equity in the combo?)
 - Methodology
 - It is unclear how principal loss is computed for combo notes in the CMIAO’s analysis. Combo notes are amortizing structures so a methodology to calculate losses should be defined and not simply assumed

3. Additional Information

CLO Structural Improvements

- All of the defaults on both Moody's and S&P-rated CLO tranches occurred in transactions issued before the financial crisis
- Given the structural improvements on "post-crisis" CLOs, we strongly believe that CLO default rates going forward will be even lower than the historical life-to-date levels
- "Post-crisis" structures have more subordination with credit support effectively improving by one rating level since the crisis
- As an example, below is a comparison of certain concentration limitations of two Ares-managed CLOs issued pre-crisis versus post-crisis, as well as a table showing the improvement in credit enhancement levels between "pre-crisis" and "post-crisis" CLOs

Ares Concentration Limitations			Credit Support ⁽¹⁾		
Deal	Pre-Crisis	Post-Crisis	Original Rating	Pre-Crisis	Post-Crisis
	Ares X	Ares XLVI			
Closing Date	Sept 2005	Jan 2018			
Senior Secured Loans	Min 80%	Min 96%	AAA	25.0%	35.1%
Senior Unsecured and Subordinated Debt Securities	Max 10%	Max 0%	AA	18.6%	23.6%
Structured Finance Securities	Max 5%	Max 0%	A	12.8%	17.3%
Synthetic Securities	Max 20%	Max 0%	BBB	8.1%	11.9%
Finance Leases	Max 5%	Max 0%	BB	5.6%	7.8%

(1) Wells Fargo Securities "FAQ on CLOs and Leveraged Loans", dated January 31, 2019. Credit support is defined as the amount of capital below a given tranche in the transaction

CLO Ratings

- Rating agencies rate CLO tranches much more conservatively than the actual default experience would imply
- We compare the actual life-to-date CLO impairment rates (for period 1993-2018) from a Moody's research report⁽¹⁾ to the idealized default rate over a 10-year horizon from Moody's rating methodology⁽²⁾
- The implied ratings based on actual life-to-date impairments are much higher than the ratings issued by Moody's. For example, 'Baa' to 'B' CLO tranches should be rated 'A'
- S&P-rated CLO tranches⁽³⁾ show a similar finding, where the lower mezzanine tranches ('BBB', 'BB', and 'B') should be rated two rating categories higher based on actual default experience

Rating Methodology

Rating Factor	Moody's Rating	Moody's Idealized Default Rates (10y Horizon)
1	Aaa	0.0100%
10	Aa1	0.1000%
20	Aa2	0.2000%
40	Aa3	0.4000%
70	A1	0.7000%
120	A2	1.2000%
180	A3	1.8000%
260	Baa1	2.6000%
360	Baa2	3.6000%
610	Baa3	6.1000%
940	Ba1	9.4000%
1350	Ba2	13.5000%
1766	Ba3	17.6600%
2220	B1	22.2000%
2720	B2	27.2000%
3490	B3	34.9000%
4770	Caa1	47.7000%
6500	Caa2	65.0000%
8070	Caa3	80.7000%

Moody's US CLO Historical Experience

Original CLO Rating	Life-to-Date Impairment Rate 1993-2018	Implied Rating based on Rating Methodology	Current NAIC Rating	Implied NAIC Rating
Aaa	0.00%	Aaa	1	1
Aa	0.00%	Aaa	1	1
A	0.06%	Aa1	1	1
Baa	1.34%	A3	2	1
Ba	1.76%	A3	3	1
B	1.12%	A2	4	1

S&P US CLO Historical Experience

Original CLO Rating	Life-to-Date Default Rate 1994-2013	Implied Rating based on Rating Methodology	Current NAIC Rating	Implied NAIC Rating
AAA	0.00%	Aaa	1	1
AA	0.00%	Aaa	1	1
A	0.45%	A1	1	1
BBB	0.28%	Aa3	2	1
BB	1.66%	A2	3	1
B	2.61%	Baa1	4	2

(1) Moody's Impairment and Loss Rates of Global CLO: 1993-2018, dated May 17, 2019, (https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBS_1164579)

(2) Moody's Global Approach to Rating Collateralized Loan Obligations, dated September 28, 2015 (https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBS_SF405477)

(3) S&P Twenty Years Strong: A Look Back at US CLO Ratings Performance from 1994 through 2013, dated January 31, 2014 (https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/8447971)

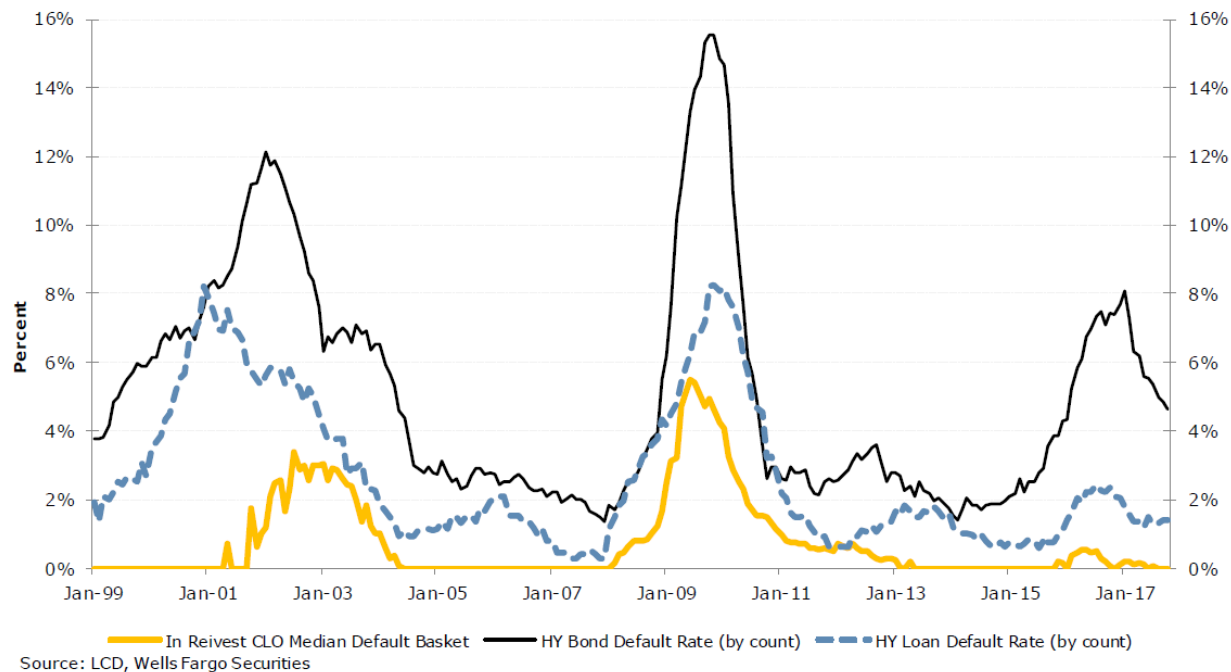
- CLOs benefit from a better structure and credit enhancement as compared to investment grade bonds

Features	CLO	Investment Grade Single Names
Senior Secured Risk	✓	✗
Diverse Portfolios of Assets	✓	✗
Structural Protections	✓	✗
Cycle-Tested	✓	✗
Non Mark-to-Market Structure	✓	✗
Locked-in Term Financing	✓	✗

- CLOs trade wide due to a complexity premium, which SBL believes it can mitigate through its market knowledge and experience

Historical CLO Default Performance

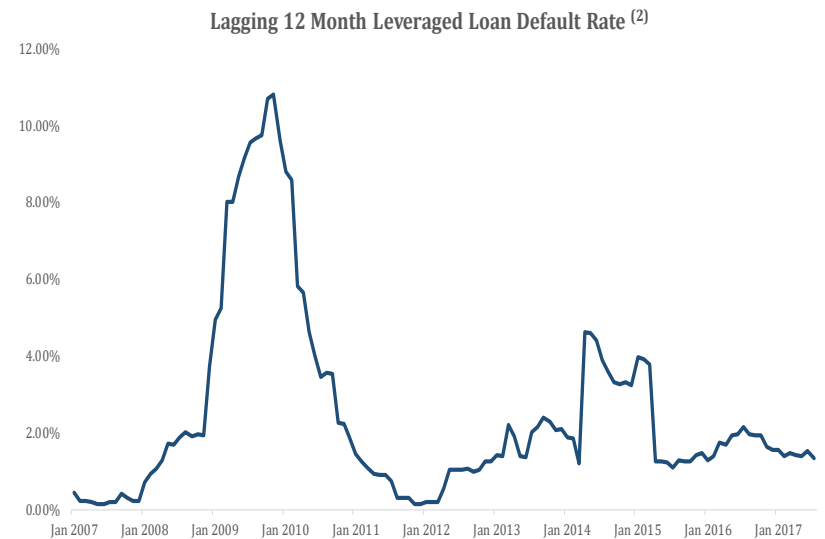
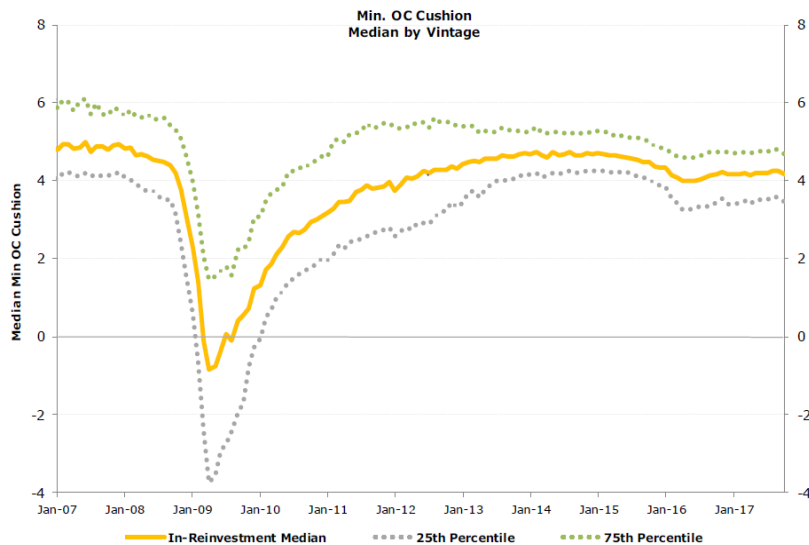
- Wells Fargo published a report⁽¹⁾ in November 2017, also showing that CLOs experienced lower than market default rates even throughout the credit crisis due to active management, which allowed CLO portfolios to perform
- During the credit crisis, CLO holdings of defaulted assets peaked at just below 6% in Q2 2009, despite the loan market default rate continuing to rise until the cyclical peak in Q4 2009



(1) "CLO's: How bad was it? CLO Market After Action Review: Part 1", dated November 29, 2017, by David Preston, Geoff Horton and Mackenzie Miller

Historical Performance on Equity Tranches (cont'd.)

- The research report⁽¹⁾ shows that at the peak of the financial crisis in the first half of 2009, over 50% of U.S. CLOs had equity distributions cut off and diverted to pay down CLO debt tranches (i.e. failure of an overcollateralization test⁽³⁾), and the average period that equity distributions were cut off was approximately two quarters
- However, even at the peak of the crisis, the top quartile of deals still had over two points of overcollateralization cushion, and the equity tranche continued to receive distributions throughout



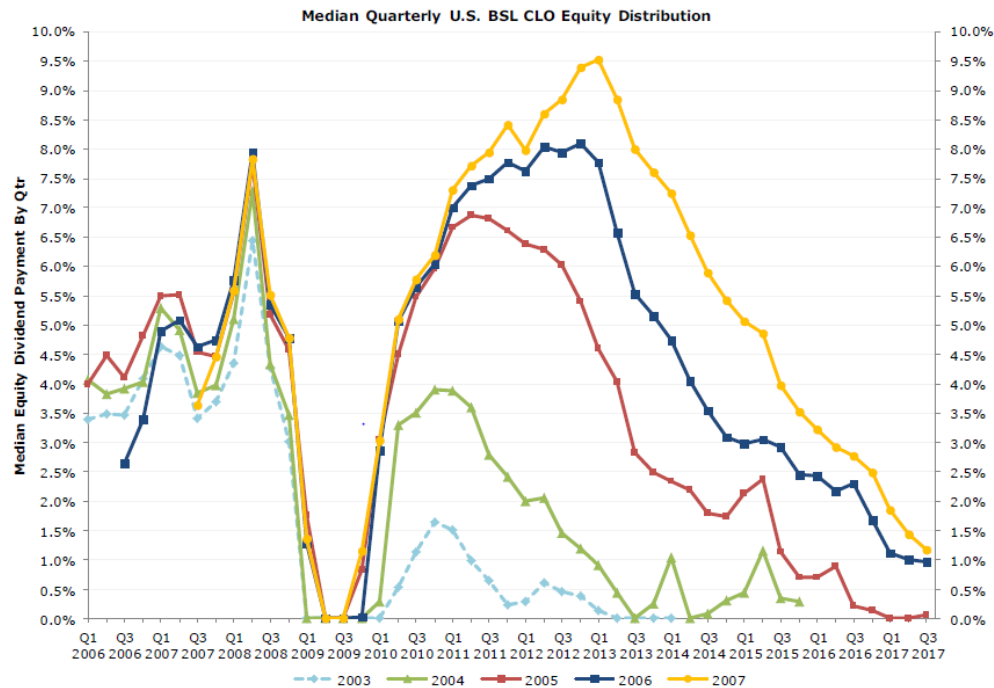
(1) "CLO's: How bad was it? CLO Market After Action Review: Part 1", dated November 29, 2017, by David Preston, Geoff Horton and Mackenzie Miller

(2) Source: S&P LCD

(3) Overcollateralization test measures the amount of asset coverage over CLO liabilities: a failure would mean that overcollateralization declined below the test level

Historical Performance on Equity Tranches (cont'd.)

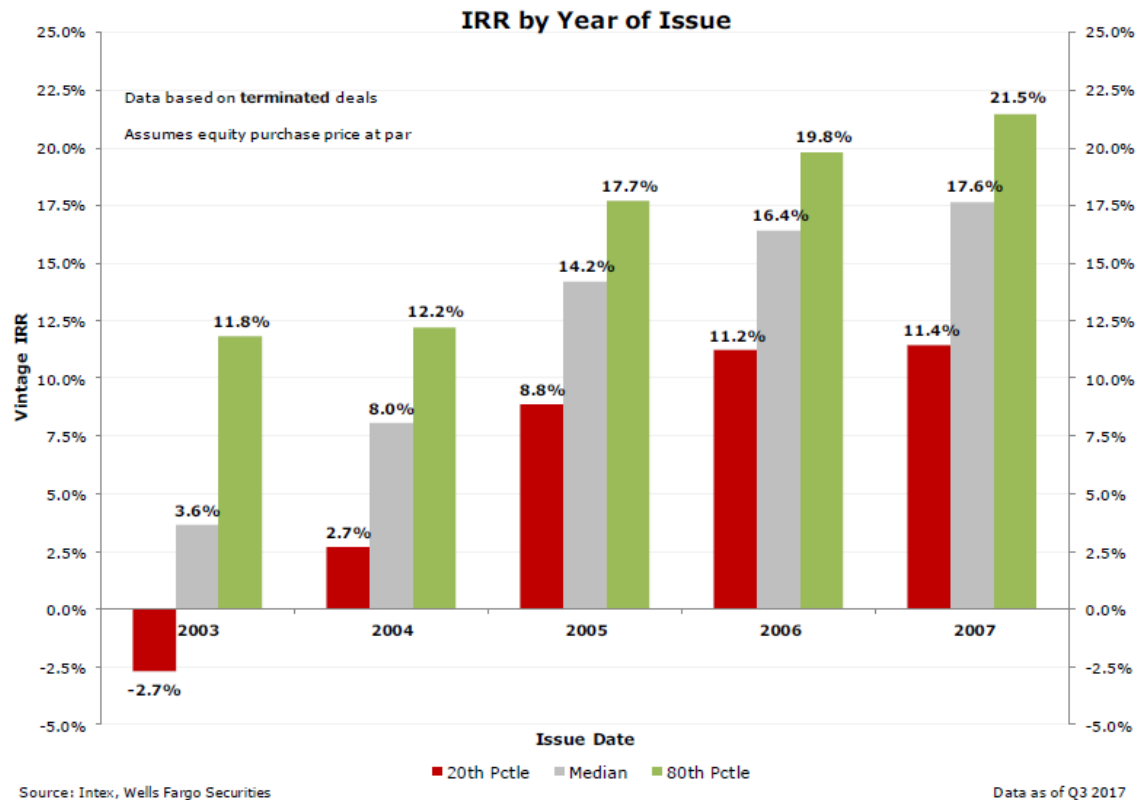
- Wells Fargo⁽¹⁾ also shows the median equity distributions, by vintage, for pre-crisis U.S. CLOs before, during and after the crisis
- Average CLO equity distributions were for only a couple of quarters in 2009. However, equity distributions recovered quickly as managers were able to take advantage of wider spreads and cheaper assets



(1) "CLO's: How bad was it? CLO Market After Action Review: Part 1", dated November 29, 2017, by David Preston, Geoff Horton and Mackenzie Miller

Historical Performance on Equity Tranches (cont'd.)

- All pre-crisis CLO equity investments had a positive IRR (except for the lowest 20th percentile of the 2003 vintage), meaning that all the equity investments received cumulative distributions that were in excess of the initial principal amount⁽¹⁾



(1) "CLO's: How bad was it? CLO Market After Action Review: Part 1", dated November 29, 2017, by David Preston, Geoff Horton and Mackenzie Miller

Third Party Research

Bank of America Research Report excerpt

- Appendix II
- Expresses many of the same misgivings about the CMIAO reports

Appendix II

NAIC's stress tests of insurers' CLO exposure

In December 2019, the National Association of Insurance Commissioners (NAIC) put out a report² outlining the findings of its stress tests of US insurers' CLO exposure. NAIC generated stress tests showed that losses "only reach BBB rated tranches even under the worst case scenario" but "reached AA-rated securities" for "atypical" CLO tranches. We think the NAIC's combination of (1) high default assumptions, (2) excessively low stressed recovery rates, and (3) the lack of credit to CLO management function create an unrealistically stressful analysis that produced losses surpassing those seen through the Great Financial Crisis (GFC), which we already consider a high water mark for the next potential cycle turn. The conclusions on CLO combination notes also drew some eyebrows, as NAIC-projected losses appear disproportionately large when pitched against historical CLO equity performance.

Background of the study

The NAIC cited recent regulatory interest in leveraged loans and CLOs as motivation for the study, while we also believe the rising participation from insurance companies in the asset class put them on the NAIC's radar. In another report³ published by NAIC in June 2019 titled "U.S. Insurance Industry's Exposure to Collateralized Loan Obligations as of Year-End 2018," it was estimated that US insurers held approximately \$122bn of CLOs in book/adjusted carrying value by YE 2018.

The NAIC stress tests were run on three simulations based on two sets of defaults and recovery assumptions. The test scenarios are outlined as follows:

Table 1: NAIC stress test scenarios

Scenario	Default Rate	Recovery Rate
A	Historical	Historical (snr sec loan = 64%)
B	Historical	Stepdown (snr sec loan = 40%)
C	Historical + 1 σ (std. dev)	Stepdown (snr sec loan = 40%)

Source: NAIC

In this report, the NAIC constructed their own default vectors based on Moody's historical corporate default data. To stress the bonds even further, the agency added one standard deviation to the "historical" default vectors in the most stringent test scenario (Scenario C, Table 1). The historical 1st lien loan recovery rate was assumed to be 64%, which is borrowed from Moody's estimation of 1st lien loans' \$-weighted recovery based on trading prices. The agency then applies "stepdown" recovery assumptions to Scenario B & C, assuming senior secured loans will recover similar to unsecured bank loans in the next downturn (40%). The stress tests do not take into account the role of CLO managers, a commonly observed feature in most CLO stress test models due to the modeling complexities of such tasks – in particular, the ability to buy and sell distressed assets in order to build par.

Projected losses CLO debt tranches appear out of range with historical data

After applying the aforementioned assumptions to a sample of \$96bn of "normal" CLOs held by insurance companies by YE18, the NAIC found that losses may reach up to BBs in the most benign scenario (A) while potentially impacting even IG-rated BBBs in the most severe set of assumptions (C). Most striking to us is the loss projections that the NAIC arrived at for lower mezzanine CLOs, which suggest that half to almost all principal invested in CLO BB-Bs will be wiped out in Scenario B and C (Table 2).

² NAIC, *Collateralized Loan Obligations – Stress Testing U.S. Insurers' Year-End 2018 Exposure*, Dec 2019

³ NAIC, *U.S. Insurance Industry's Exposure to Collateralized Loan Obligations as of Year-End 2018*, June 2019



Table 2: Projected principal losses on “normal” CLO tranches

Lowest Rating	Mapped Exposure	Scenario A		Scenario B		Scenario C	
		Loss	Loss %	Loss	Loss %	Loss	Loss %
AAA	43,729	-	0.0%	-	0.0%	-	0.0%
AA	22,701	-	0.0%	-	0.0%	-	0.0%
A	15,204	-	0.0%	-	0.0%	-	0.0%
BBB	11,525	-	0.0%	-	0.0%	1,942	16.9%
BB	2,465	7	0.3%	1,126	45.7%	2,344	95.1%
B	174	74	42.5%	169	97.0%	171	98.6%
CCC	11	10	89.1%	11	100.0%	11	100.0%
Total	95,808	91	0.1%	1,305	1.4%	4,469	4.7%

Source: NAIC

Table 3: Projected principal & interest losses on “normal” CLO tranches

Lowest Rating	Mapped Exposure	Scenario A		Scenario B		Scenario C	
		Loss	Loss %	Loss	Loss %	Loss	Loss %
AAA	43,768	-	0.0%	-	0.0%	-	0.0%
AA	22,684	-	0.0%	-	0.0%	-	0.0%
A	15,202	-	0.0%	-	0.0%	-	0.0%
BBB	11,525	-	0.0%	-	0.0%	3,040	26.4%
BB	2,487	12	0.5%	1,612	64.8%	3,584	144.1%
B	174	132	75.9%	265	152.6%	275	158.0%
CCC	11	11	101.8%	13	116.3%	13	118.6%
Total	95,852	155	0.2%	1,890	2.0%	6,912	7.2%

Source: NAIC

These numbers were much higher than historical cumulative losses on US CLOs, as provided in a 2019 Moody's report⁴ (Table 4). According to Moody's estimations, 10-year cumulative losses totaled less than 12% among 358 CLO tranches rated single-B at issuance in the period from 1993 to 2018, which, of course, includes the GFC. That said, Moody's attributed the jump in estimated loss rates among single-B CLOs from year 5 to year 6 (2% to 12%) to the small universe outstanding beyond that point, as the majority of B-rated CLOs were issued after 2014. Meanwhile, BB CLO 10-year cumulative losses totaled just below 4% in a sample of 1477 bonds.

Table 4: US CLOs, Estimated ,multi-year cumulative loss rates by original rating, 1993-2018

	Cohort size (#)	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
Aaa	3,833	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Aa	1,961	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
A	1,816	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Baa	1,791	0.0%	0.0%	0.0%	0.3%	0.3%	0.3%	0.4%	0.9%	1.2%	1.2%
Ba	1,477	0.0%	0.0%	0.3%	0.6%	0.8%	1.0%	1.0%	2.0%	2.8%	4.0%
B	358	0.0%	0.0%	1.7%	1.7%	1.7%	11.8%	11.8%	11.8%	11.8%	11.8%
Investment-Grade	9,401	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.2%	0.3%	0.3%
Speculative-Grade	1,836	0.0%	0.0%	0.5%	0.8%	0.9%	1.3%	1.3%	2.3%	3.1%	4.3%
All	11,237	0.0%	0.0%	0.1%	0.2%	0.2%	0.3%	0.3%	0.5%	0.7%	0.9%

Source: Moody's

In the same report, Moody's also stated that no CLOs rated by the agency since 2009 have been impaired to date, implying all losses were associated with CLO 1.0s. All else equal, CLO 2.0s should in theory see lower losses than their pre-crisis counterparts due to higher structural subordination (Table 5). Therefore, the 42% loss on single-B CLOs projected by NAIC even in their most benign stress scenario (A) seems unrealistic in our opinion.

Table 5: Volume-weighted credit support for BSL CLO 1.0s and 2.0s

	B	BB	BBB	A	AA	AAA
CLO 1.0 (2003-2009)	9%	9%	12%	16%	22%	28%
CLO 2.0 (2010+)	10%	10%	15%	20%	27%	38%

Source: BofA Global Research

⁴ Moody's, *Impairment and loss rates of global CLOs: 1993-2018*, May 2019

Default assumptions

We believe such distinct variations in NAIC projected losses and historical figures for US CLOs stem from the agency's model inputs and thus set out to further understand the underlying assumptions. In their methodology, the NAIC employed a cohort-averaging approach to derive the historical default vectors. Specifically, the agency chose to average Moody's default vectors⁵ only from annual cohorts where at least 10 years of history was available, weighted by issuer count. This limits the sample to loans issued between 1970 and 2009, which in our opinion represents a mismatch with the current collateral and structural profile of US CLOs where the overwhelming majority of underlying loans are issued post-crisis.

Comparing the NAIC-generated default vectors (Table 6) with Moody's own averaged cumulative default vectors (Table 7) which consist of data from 1983 to 2018, the difference in default assumptions range from as little as 1% for Ba1-rated issuers to almost 12% for those rated Ca-C. While the average concentration of loans rated Caa and below by Moody's among US CLOs still hover around 4%, we estimate that loans rated B1 to B3 made up almost 75% of rated CLO collateral ex. defaults as of YE19, making assumptions on these rating buckets most instrumental in driving projected losses. This would translate to default assumptions on issuers rated B2 to Caa, as senior secured loans are often rated one notch higher than their respective corporate family rating.

Table 6: NAIC's "historical" default vectors by issuer rating and years into seasoning, 1970-2009

	1	2	3	4	5	6	7	8	9	10
Ba1	0.6%	1.8%	3.1%	4.4%	5.8%	7.2%	8.2%	9.0%	9.8%	10.7%
Ba2	1.0%	2.4%	3.9%	5.4%	6.8%	8.0%	9.1%	10.4%	11.8%	13.4%
Ba3	1.8%	4.8%	8.0%	11.6%	14.6%	17.5%	20.0%	22.4%	24.7%	26.7%
B1	2.7%	6.7%	10.9%	14.7%	18.5%	21.9%	25.3%	28.2%	30.8%	32.9%
B2	4.0%	9.8%	15.1%	19.7%	23.4%	26.8%	29.7%	32.1%	34.3%	36.4%
B3	6.5%	13.6%	20.2%	25.7%	30.4%	34.4%	37.9%	40.9%	43.5%	45.5%
Caa	12.8%	23.1%	30.9%	37.1%	41.7%	45.4%	48.2%	51.0%	53.6%	55.8%
Ca-C	49.8%	61.5%	67.6%	70.8%	71.5%	71.5%	72.5%	73.4%	73.4%	73.4%

Source: NAIC

Table 7: Moody's average cumulative issuer-weighted default rates by issuer rating, 1983-2018

	1	2	3	4	5	6	7	8	9	10
Ba1	0.4%	1.4%	2.6%	3.8%	5.1%	6.3%	7.2%	7.9%	8.7%	9.5%
Ba2	0.7%	1.9%	3.3%	4.7%	6.0%	7.0%	8.0%	9.2%	10.5%	11.8%
Ba3	1.4%	3.8%	6.8%	10.1%	12.7%	15.3%	17.6%	19.8%	21.8%	23.7%
B1	2.0%	5.3%	8.9%	12.4%	16.0%	19.3%	22.5%	25.3%	27.7%	29.7%
B2	3.0%	7.7%	12.4%	16.7%	20.3%	23.6%	26.4%	28.7%	30.9%	32.9%
B3	4.9%	10.7%	16.6%	21.7%	26.3%	30.3%	33.7%	36.7%	39.1%	41.1%
Caa	7.9%	15.3%	21.9%	27.4%	32.2%	36.0%	39.1%	42.1%	45.0%	47.3%
Ca-C	30.7%	40.9%	47.7%	52.4%	55.1%	56.4%	58.9%	60.6%	61.5%	61.5%

Source: Moody's

From Table 6 and Table 7, the discrepancy in NAIC's and Moody's methodology and sampling horizon produced differences of 3.5%, 4.5% and 8.5% for issuers rated B2, B3, and Caa at year 10. We believe the recalculation of such default vectors by NAIC to (1) extend the sample to cover data from 1970 (vs. 1983 as provided by Moody's) and (2) maintain the 10-year data availability in all sampling cohorts is unwarranted as it comes at the expense of recent data points that are more relevant to the population of loans underlying currently outstanding CLOs. Limiting the default sample to just pre-2009 entries also does not account for the structural change in loan documentation over time, where the rise of cov-lite structures give issuers a longer runway to default compared to their pre-crisis counterparts. As such, these default assumptions do not align with our

⁵ Moody's, *Annual default study: Defaults will rise modestly in 2019 amid higher volatility*, Feb 2019



view that, due to the rise in cov-lite, the next spike in loan defaults is likely to be shallower compared to the GFC experience.

On another front, since Moody's cohort data that underlies NAIC's calculations were only made available at the broad (letter) rating level (ex: Ba), we believe NAIC's approach of scaling the letter default vectors by historical rating distributions to arrive at alphanumeric default vectors (ex: Ba1, Ba2, Ba3) make the assumptions more prone to errors and are more likely to misrepresent the actual historical default experience of corporate issuers.

For the reasons mentioned above, we prefer Moody's default vectors ('83-'18) to those employed by the NAIC ('70-'09) when running these simulations, especially when the NAIC proceed to employ recovery assumptions that were aggregated over the period from 1983-2018 and not 1970-2009 as we will further examine below.

Recovery assumptions

Recovery assumptions in NAIC's stress tests mostly follow their stress thesis that "the consequences of less stringent underwriting on the underlying bank loan collateral will result in substantially lower recovery rates during the next recession". Both the "historical" and "stepdown" versions of assumed recoveries were based on Moody's historical averages of trading price recovery for 1st lien and senior unsecured bank loans in the period from 1983 to 2018, respectively. The "historical" recovery rate was thus set at 64% for senior secured loans, which seems reasonable and falls into the mid-range of the current market where traders usually price bonds to 60%-70% recovery depending on the manager and portfolio construct.

However, we don't necessarily endorse the use of historical senior unsecured loan recoveries (40%) to reflect future loan recoveries in NAIC's "stepdown" scenarios. Firstly, there were simply not enough senior unsecured loans issued historically to provide a statistically robust dataset. To quote some numbers, the 64% 1st lien bank loan recovery calculation provided by Moody's was backed by 501 issuers (\$299bn), while the 40% recovery on senior unsecured loans was supported by only 69 observations (\$35bn).

While we acknowledge that the prevalence of cov-lite loans has made it harder for loans to go under and might drag down the quality of pool that eventually default, the comparison between secured and unsecured loan obligations seems to be a stretched effort in factoring in the deterioration in loan documentation over time. If we were made to choose an alternative, historical recoveries on 1st lien bond (secured) seem to better serve NAIC's purpose in carrying out their stress thesis. In the same Moody's report, this volume-weighted recovery was estimated to be around 55% and backed by a sizeable sample of more than 300 issuers totaling almost \$150bn in dollar volume, a significantly larger sample than that of senior unsecured loans.

Combo notes on the chopping block, lacking transparency in methodology

After putting "normal" CLO tranches through these tests, NAIC also put tranches with so-called "atypical" payment promises such as equity tranches or combination notes through the ringer. While NAIC did not calculate losses of equity tranches due to the unpredictability of distributed cash flows, they did run the analysis through CLO "combo notes." As a refresher, CLO combo notes are securities that repackage cash flows from existing CLO notes into a single security. While the structure of such bonds may vary, the most common type of combo notes usually combine principal and interest paying notes (usually mezz bonds and an equity piece) into a principal-only note that can have a blended rating higher than some of its respective constituents. As such, the assigned rating is typically rated on a principal-only structure where interest and all principal cash flow from the underlying CLO components are directed towards paying down the principal balance of the combo notes, creating overcollateralization⁶. According to

⁶ Morningstar, *Frequently Asked Questions About CLO Combination Notes*, Feb 2019



Morningstar, which rated more than 60 combination notes as of YE18, such notes were predominantly assigned BBB- ratings but have seen ratings as high as single-A.

NAIC stress tests claimed that, under their scenarios, principal losses to combo notes can average about 28% in the Scenario A and 30% in Scenario C, mostly driven by halted payments of the equity portion. While these figures look particularly eye-popping, the NAIC provided little transparency on how such losses were actually calculated based on the set of assumptions laid out above, making it hard for us to rebut these findings from a methodology perspective.

That said, we still have several reasons to be skeptical of these results. First of all, the small differential between average losses in Scenario A and C look particularly unusual given the significant step up in assumed defaults (1 standard deviation) and haircut on recovery assumptions (24%).

Second, NAIC disclosed that it was able to map and model only \$1bn in “atypical” CLO notes, which include both CLO equity and combo notes. It is unclear what’s the notional amount underlying their findings for CLO combo notes’ stress tests, but given the already small size of this pool of “atypical” notes, we do not believe this to be a fair sample of the CLO combo note universe, many of which are privately placed and vary in structures.

Third, it was unclear whether equity cash flow shutdowns were modeled as a lifetime or temporary event in NAIC’s stress tests. Based on Intex historical data, we saw that the majority of CLO equity tranches that experienced cash flow shutdowns during the Great Financial Crisis eventually resumed paying in 2010-2011. In fact, the majority of CLO 1.0 equity enjoyed double-digit IRRs in our estimation, even with the very conservative assumption that these notes were priced at par. In our sample of 377 equity tranches from 1.0 CLO deals that have paid off, only 10% saw negative IRRs (Chart 1). In reality, many of these deals might not have experienced any time-weighted losses if the notes were acquired significantly below par, which is very often the case.

Chart 1: Distributions of CLO 1.0 equity IRRs for paid off deals, assuming notes are priced at par



Source: BofA Global Research, Intex

Given equity cash flows are used to pay down principal balance on the combo notes, coupled with CLO 1.0 equity’s resilient performance even throughout the GFC, NAIC’s 28%-30% principal losses on CLO combo notes do not seem to be a fair estimation in our view.





MEMORANDUM

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
 Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office

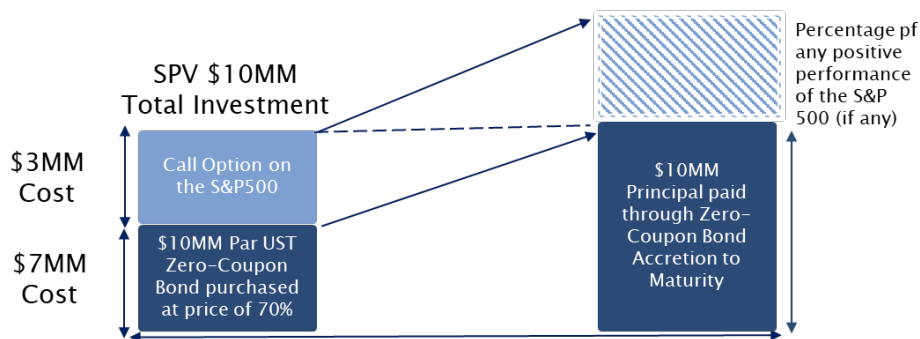
CC: Eric Kolchinsky, Director, NAIC Structured Securities Group

DATE: July 2, 2019

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)* to Update the Definition and Instructions for Principal Protected Notes

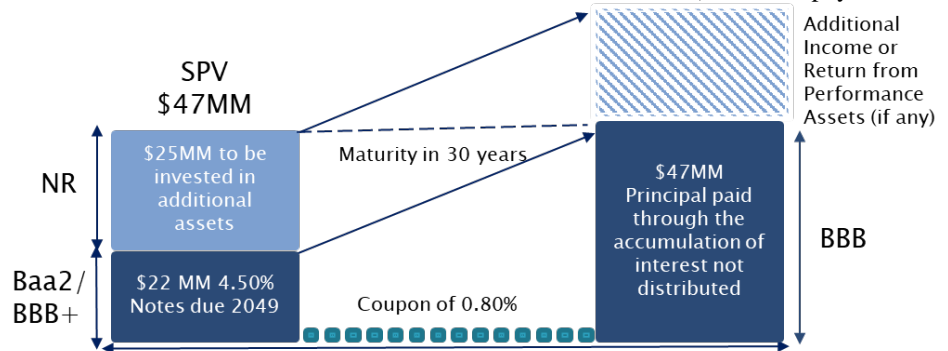
1. **Introduction** – The SVO proposes a substantive amendment to the P&P Manual to update guidance in Part Three under the Procedure Application to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities, Specific Populations of Securities Not Eligible for Filing Exemption. The SVO has become aware of a class of structured securities, known as Principal Protected Notes, that mixes a traditional bond or bonds with additional assets that may possess any characteristic. These additional assets are intended to generate an excess return, we call them the “performance assets;” such as, derivatives, common stock, commodities, equity indices, etc. . . . essentially any asset. The performance assets may include undisclosed assets and are typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond
2. **Analytical Concern** – The SVO has reviewed a dozen or more of these securities. They share a consistent theme; the external credit rating provider (CRP) rating is based solely on the component dedicated to the repayment of principal and ignores the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1. There are many potential variants of this structure, for simplicity I have included examples of two common forms below. While the transactions details have been changed to maintain confidentiality the examples accurately reflect the risks and assets embedded within these structures.

- a. In this initial example there are only two components: 1) a \$10 MM par UST zero-coupon bond sold at discount (ex. \$70) from par (\$100) that will pay par (\$100) at maturity and 2) a return linked to any



positive performance of call options on the S&P 500 Index (if the S&P 500 Index has a negative performance, investors will only receive an amount equal to their initial investment). The external rating would be AAA, based solely on the risk of the UST security.

- b. In the second example there are multiple components: 1) a \$22MM corporate bond paying a fixed coupon (ex. 4.50%) with a stated maturity date (ex 9/30/2049), 2) the corporate bond has two NRSRO ratings (Moody's Baa2, S&P BBB+), 3) the SPV invests \$25MM in additional undisclosed and unrated assets, 4) the SPV pays a semi-annual coupon of 0.80%, 5) the excess coupon difference (4.50% - 0.80% = 3.70%) is used to accumulate into the required principal to pay at maturity and 6) a different NRSRO rated the PPN a BBB, again based solely on the corporate bonds that represent less than 50% of the total investment in this example.



In both examples, assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that schedule through financial structuring. Significant risks are being obscured by focusing only risk associated with the repayment of principal. The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche.

3. **Recommendation** –The SVO proposes removing this class of securities from eligibility for Filing Exemption. The SVO has existing methodologies that can applied to assess the overall risk of these structures and, to the extent that the SVO identifies possible affiliated assets, the SVO would alert regulators. The SVO also recommends referring this memorandum to the Statutory Accounting Principles (E) Working Group to consider the treatment of the asset transformations described above.
4. **Proposed Amendment** – The proposed amendment is shown below in red-underline.

Part Three SVO Procedures and Methodology for Production of NAIC Designations

PROCEDURE APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL) RATING SECURITIES

...

Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:

...

- Principal Protected Notes (PPN) – PPN (sometimes called “Principal Protected Securities,” “Principal Protected Loans,” or “Combo Notes”) are a type of structured security where a portion of the underlying assets are dedicated to ensure the repayment of principal at maturity or a third party may guarantee the repayment of principal at maturity. The remaining assets in the structure, the performance assets, are intended to generate additional returns and may be of a type (ex. derivatives, equities, commodities, non-CRP rated debt, loans, funds, private equity, real estate, affiliated, undisclosed, etc.) that would not be eligible for reporting on Schedule D. Investments in PPNs must be submitted to the SVO for analysis.



September 20, 2019

Submitted electronically to ctherriault@naic.org and dgenaorosado@naic.org

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Dear Mr. Fry:

We appreciate the opportunity to comment on the Valuation of Securities Task Force (the “Task Force”) exposure regarding the ‘Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update the Definition and Instructions for Principal Protected Notes’ (the “Exposure”). We support the Task Force’s and SVO’s objective to provide solutions to investment-related regulatory issues for existing or anticipated investments. We recommend however, that:

- the proposed definition of PPNs be made more clear and less encompassing;
- the Task Force consider the accounting treatment’s impact to capital as well as the proposed changes’ impact on required capital;
- the Task Force provide more transparency into the process that would be utilized to assign ratings for PPN;
- the Task Force consider potential materiality of exposure to the change and the timing of implementation.

Commentary in the Introduction Section

The Exposure states:

These additional assets are intended to generate an excess return, we call them the “performance assets;” such as, derivatives, common stock, commodities, equity indices, etc. ... essentially any asset. The performance assets may include undisclosed assets and are typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond.

The SVO has reviewed a dozen or more of these securities. They share a consistent theme; the external credit rating provider (CRP) rating is based solely on the component dedicated to the repayment of principal and ignores the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1.

Based upon the language above, it appears the Task Force has two primary concerns:

- **Concern 1:** Schedule D structured securities whose return is supported by assets not eligible for Schedule D reporting; and
- **Concern 2:** Ratings that reflect the risk of loss of principal and a small coupon, but do not reflect the risk of loss of potential additional returns.

Concern 1

An investment is reported on schedule D, Part 1 through: *SSAP No. 26R - Bonds* (“26R”) or *SSAP No. 43R - Loan-Backed and Structured Securities* (“43R”).

- 26R exists for investments that have a creditor relationship, whereby there is a fixed schedule for one or more future payments. Essentially, 26R investments have 1) principal amount due and 2) interest amount due.
- 43R exists for investments that have payment of interest and/or principal based upon payments received by the issuer from underlying assets.

Neither 43R, nor to our knowledge, state investment laws or the NAIC model investment law, require the underlying assets to be a 26R eligible asset. Otherwise stated, 43R does not prohibit underlying assets that would otherwise be ineligible for schedule D reporting under 26R. If such a requirement existed, we believe 43R would have less relevance. 43R allows for income generating investments that support insurance company liabilities and asset liability matching (“ALM”) core to an insurance company’s operations.

Additionally, we believe concerns with certain investments under 43R are already actively addressed by the Statutory Accounting Principles Working Group (“SAPWG”) through the following:

- adoption of changes to SSAPs 2R, 26R, 43R, and 86 that require structured notes to be accounted for as derivatives; and
- exposure of changes to 43R to exclude structures with underlying equity interests from the scope of the statement.

Concern 2

We agree with the Exposure that the CRP rating of a PPN is typically directionally consistent (*e.g.*, typically equivalent to +/- 1 notch) with the rating of the component dedicated to the repayment of principal and coupon (*e.g.*, the rating on the underlying corporate bond), and largely ignores the risk and return of the performance asset.

The reason for the rating equivalence is very important, but not mentioned in the Exposure. The reason the ratings are equivalent is that the contractual terms of the PPN (typically repayment of principal plus a small coupon, say 1%) are fully satisfied by the component dedicated to the repayment of principal and coupon. It is logical and definitionally consistent that since 100% of the contractual terms of the PPN are satisfied by, say a BBB-rated corporate bond, that the rating of the PPN would be BBB. Indeed, the risk asset(s) can immediately go to zero and as long as the BBB-rated corporate asset satisfies its principal and interest payments, the insurance company will get all of its investment back plus the small coupon. Additionally, and very importantly, an accounting impairment, which is an immediate reduction to surplus, would likely occur in this situation.¹

¹ In 2006, the Task Force raised concern that the carry value of a PPN would not represent the amount available to meet current and future obligations of the insurance company if the underlying risk asset(s) was not performing, as the market value of such investment would likely be less than the principal amount. This was because 43R, at that time, only required the use of undiscounted cash flows for assessment of impairment. Accordingly, as long as the “safe” asset(s) was

A separate Task Force presentation delivered to the Task Force at the NAIC's 2019 Summer National Meeting entitled "Bespoke Securities" stated the SVO would rate a NAIC 1 PPN as a NAIC 5.² At an 800% ACL RBC level (representative of the level of capital that many insurers hold and before covariance, taxes, or concentration), an insurance company holds 1.6% capital for a NAIC 1 investment and 89.24% capital for a NAIC 5 investment. The proposed change in rating represents a 5,600% increase in required capital for an investment whose contractual terms are 100% satisfied by an A-rated or better asset. This appears very punitive as to an asset on which an insurer is still expected to recover principal and coupon in an adverse business, financial, or economic condition, doubly so considering an impairment through surplus would typically be recognized when the additional asset(s) is not performing.

In short, we believe that the ability of PPNs to satisfy current and future obligations is appropriately managed through the combination of 1) the CRP rating and 2) use of discounted cash flows to assess impairment.

Commentary in the Analytical Section

The Exposure states:

In both examples, assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that schedule through financial structuring. Significant risks are being obscured by focusing only risk associated with the repayment of principal. The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche.

Regarding "*Significant risks are being obscured by focusing only risk associated with the repayment of principal,*" we believe the return of principal is a significant risk in and of itself. We acknowledge that the potential for additional return above the stated coupon may not be rated; however, as noted above, statutory accounting principles exist to regulate income recognition and carry value. Furthermore, we would note that 10-year Investment Grade Public Corporate Bonds were issued in September 2019 with coupons as low as 2.20%, with no potential for additional income. An investor could also purchase a NAIC 1 PPN with a 1% contractual coupon, but have the potential and expectation for meaningful additional returns. The NRSRO ratings suggest that both investments have the same likelihood to return contractual payments; however, the PPN could provide additional returns, potentially well above the 2.20% coupon. Additionally, statutory accounting would typically require the PPN to be impaired when the investor is not expected to recover the originally projected cash flows

performing, future undiscounted cash flows would always support the principal amount, and there would be no impairment even though the risk asset(s) was not performing.

The Task Force referred its concern to the SAPWG, which resulted in substantive revisions to 43R that required the use of discounted cash flows using the original book yield to assess impairment. Accordingly, if the risk asset(s) is (are) not performing, there are less future cash flows, which typically results in impairment. This revision resulted in close alignment of the carry value of PPNs with the amount that would be available to meet current and future obligations.

² The analytical details behind the rating were not disclosed; however, an NAIC 5 is equivalent to a S&P CCC rating. S&P defines a CCC rating as one that is "currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitments on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitments on the obligation."

(1% plus estimate of additional returns); however, the corporate bond would only be impaired when the investor does not expect to recover principal and coupon (2.20% in this example).

Regarding “*The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche,*” we believe statutory accounting principles governing affiliated transactions ameliorate these concerns, particularly with the principle application of SSAP No. 25—*Affiliates and Other Related Parties*. As such, a PPN would have to be designated as affiliated if the return of the PPN is predominately provided by affiliated investments. Additionally, SSAP No. 25 requires that affiliated investments be arm’s-length, fair, reasonable, and economic.

Proposed Amendment

The proposed amendment is as follows:

Principal Protected Notes (PPN) – PPN (sometime called “Principal Protected Securities,” “Principal Protected Loans,” or “Combo Notes”) are a type of structured security where a portion of the underlying assets are dedicated to ensure the repayment of principal at maturity or a third party may guarantee the repayment of principal at maturity. The remaining assets in the structure, the performance assets, are intended to generate additional returns and may be of a type (ex. derivatives, equities, commodities, non-CRP rated debt, loans, funds, private equity, real estate, affiliated, undisclosed, etc.) that would not be eligible for reporting on Schedule D.

We would urge you to consider revisions to the following proposed amendment defining PPN and have provided suggested language below. We believe this revised definition would provide the industry with the clarity and specificity which will result in consistent implementation of the exposure while at the same time capturing both examples provided in the body of the exposure.

Principal Protected Notes (PPN) – are a type of investment where payment of contractually promised fixed cash flows (principal and interest thereon) is satisfied by an underlying bond(s), but additional potential returns are generated by non-fixed-income assets in the structure which, if held directly, would be reported on Schedule D – Part 2 – Section 2 – common stock, Schedule A – real estate, Schedule DB – derivatives, or Schedule BA – private equity funds, hedge funds, other equity funds in the form of LP/LLC structures or characteristics of common stock. Investments in PPNs must be submitted to the SVO for analysis.

Summary

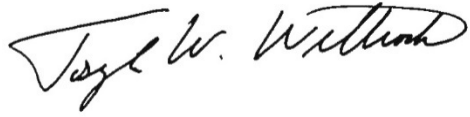
In summary, we suggest the following steps be considered as the Exposure proposal moves forward:

1. consider the revised language we have provided above which we believe creates a clear and specific definition of what constitutes a PPN so any amendment can be consistently implemented;
2. consider how existing accounting treatment’s impact to capital (*i.e.*, impairments) would align with proposed changes to required capital;
3. provide more transparency into the process which would be utilized to assign NAIC ratings for PPN investments;
4. request feedback from the industry on potential materiality of exposure given the definition and rating process for PPNs; and

5. use the feedback from #4 above to gauge the impact on the industry and the associated timing of implementation.

We hope you find our comments to be constructive and helpful as the Task Force considers solutions to address PPNs.

Sincerely,

A handwritten signature in black ink, appearing to read "Joseph W. Wittrock". The signature is fluid and cursive, with a large initial "J" and "W".

Joseph W. Wittrock, CFA
Senior Vice President and Chief Investment Officer

Mr. Kevin Fry, Chair

NAIC Valuation of Securities (E) Task Force

1100 Walnut Street, Suite 150

Kansas City, MO 64106

Dear Mr. Fry,

We appreciate the opportunity to comment on the proposed amendment to the Purposes & Procedures Manual of the Investment Analysis Office (P&P Manual) to update the definition and instructions for Principal Protected Notes (PPN) and Combo Notes, and removing these classes of securities from eligibility for Filing Exemption (FE).

We strongly support the stated objective of the NAIC Securities Valuation Office to improve asset risk transparency, capital treatment, and proper scheduling for Principal Protected Notes (as defined), Combo Notes, and other structured securities. However, we are concerned that the broad based application of the proposed amendment, as currently contemplated, will result in significant unintended consequences, particularly with respect to structured notes or securitized assets generally. The issues posed should be given proper consideration and analysis. The NAIC should allow for industry comment and involvement in crafting a new rule, which should be appropriately scoped and implemented.

PPN Comment:

The recent proposal from the SVO recommending elimination of the the filing exemption for Principal Protected Notes and to adjust capital requirements due to the perceived riskiness of these securities conflates various forms of structured credit that exist in the market into one overly broad category. The description used by the NAIC is broad and has been interpreted differently by industry participants. As a result, the definition does not draw a clear distinction between the intended target and other structured financings eligible for schedule D reporting such as LBASS securities under SSAP 43R. The industry needs more clarity on how these particular notes are defined as opposed to other structured finance vehicles.

The SVO bases its position on several elements: (i) the notes at issue may include assets that would not otherwise be permitted on Schedule D; (ii) the assets being transferred into the structure are not transparent and may be affiliated with the insurer, and (iii) the SVO's capacity to designate these assets.

Schedule D: The concern with respect to proper scheduling is inconsistent with current practice across asset classes. Reporting structured notes with underlying assets that are technically ineligible for schedule D, occurs regularly. For example, CMBS, RMBS, ABS, are all examples of common general account investments that appear on Schedule D but contain underlying assets that would otherwise appear on other schedules. An NRSRO rated note or bond with bond-like cash flows and bond characteristics is properly scheduled on Schedule D. *We recommend that the proposed amendment be limited to require SVO filings only in those cases where the underlying assets are not schedule D eligible assets or are assets without*

bond or bond-like cash flows. This is consistent with the SVO's presentation on bespoke securities dated 8/4/2019.

Transparency/Affiliation: We are in favor of improved transparency and disclosure requirements around any affiliated transactions. Concern regarding affiliated investments is also being addressed by SAPWG 2019-03 changes to SSAP 25 regarding affiliated investments, which requires disclosure and additional look-through analysis to identify related parties. Requiring a filing based on a look-through analysis is inconsistent with existing practice as Statutory Accounting Principles do not allow for the consolidation of assets. *Potential issues of transparency, specifically with respect to statutory affiliation, are addressed by SSAP 25.*

SVO Capacity to Designate: Recently, the SVO has taken on additional responsibilities as it relates to privately rated assets with the adoption of rules that require filing rating letters. Prior to taking on even more responsibilities, the SVO should establish clear methodologies that address the concerns of the SVO as well as demonstrates the SVO's ability to designate these assets prior to eliminating the reliance of Nationally Recognized Statistical Rating Organizations (NRSRO). Based on the letter from the SVO to the VOSTF, it is not clear if the SVO is aware of the number, size and complexity of the PPN assets currently held by insurers.

Combo Note Comment:

Combo Notes are mentioned but not defined or analyzed in the 8/4/19 memo to the VOSTF, and are also referenced in a recent LCD article as a targeted investment.

Combo notes are distinctly different from the type of asset the NAIC is describing when discussing PPNs. Contrasting features include the following: i) the underlying assets are all schedule D assets; ii) the manager or 3rd party equity shares the first loss risk; iii) the subordinated note is not disregarded for the rating, but rather sensitized and modeled out by an NRSRO; and iv) the notes include many different investors and are marketed broadly.

Combo Notes also do not meet the definition of "bespoke security", which was also raised as an area of concern. The NAIC broadly defines a "bespoke security" as one that is: i) not broadly syndicated (i.e. owned by many parties); ii) created by or for one or a few related insurance companies as an investment and; iii) assigned a credit rating by only one NAIC CRP, often via a private rating. Combo Notes do not meet this criteria.

Combo notes play an important role in the issuance of CLO liabilities. Accounting changes will impact the broader bank loan and CLO market, including the estimated >\$120bn of CLO assets held by insurers. Historical loss rates on CLO assets are extremely low, provide diversity to insurer's portfolios, and can be an important asset class for insurers and their policyholders. The white paper issued by the NAIC Capital Markets Bureau on 8/5/19 on leveraged loans provides additional statistical support for the exceptional stability of this asset class. Given the previous filing exempt status and existing guidance under SSAP 43R, a change to require filing of all Combo Notes should be considered a substantive change. *Combo Notes meet the definition of a loan backed security as defined under SSAP 43R, and do not meet the definition of a Principal Protected Note as defined in the proposed modification to the P&P manual and should therefore be scoped out.*

Conclusion:

Given the issues posed above, the many open questions, and the potential unintended consequences of the proposed changes, this matter should not be fast-tracked through committee without first affording the industry meaningful opportunity to comment and provide analysis to better define scope and to define and

distinguish the risks the NAIC is looking to address. Additionally, insight into the factors and models that the SVO will use to derive a rating designation for previously FE securities would be helpful.

Thank you so much for your consideration,



Michael K. Moran

SVP & Chief Accounting Officer

September 20, 2019

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Dear Mr. Fry,

We appreciate the opportunity to provide feedback on the Valuation of Securities Task Force exposure regarding 'Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office to update the Definition and Instructions for Principal Protected Notes' ("PPNs").

As disclosed in Part One, Section 4, paragraph c) (ii) (C) of the Purposes and Procedures Manual of the NAIC Investment Analysis Office ("P&P Manual"), the NAIC has authority to determine whether it is appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of a particular asset class. While this is the case, we respectfully request clarification on the definition of the investments required to be filed under this proposal, visibility into the analysis to be conducted by the SVO, an outline for the expected time required by the SVO to produce designations on individual impacted investments and an outline for timing in which this proposal is to be applied to the preparation of Statutory Statements.

Issue background: The memorandum summarizing the issue and the SVO proposal included two examples of investments considered to be PPNs:

1. Zero coupon Treasury bond with notional equal to face amount of the PPN coupled with a call option on the S&P 500.
2. Fixed coupon corporate bond having fixed coupon that covers stated interest on the PPN with excess interest plus the principal on the corporate bond covering the face amount of the PPN. Plus additional undisclosed and unrated assets that may provide additional return.

Regarding these examples, the SVO concluded with three statements that serve as organizing principles for our response letter:

- Asset transformations: Assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that Schedule through financial structuring.
- Affiliate/related party transactions: The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche.
- SVO stated analytical concern: Significant risks are being obscured by focusing only (on) risk associated with the repayment of principal.

Asset transformations: Addressing the statement made in the proposal that both examples include assets that would otherwise be ineligible for reporting on Schedule D, the SVO recommended referring this topic to SAPWG to consider the treatment of the asset transformations described. While it should be generally understood that, most often, securitizations result in transforming many types of

underlying investments—including those not reported on Schedule D—into fixed income securities, we are supportive of such a referral should that create clarity for the industry. In fact, a topic with a similar theme (Collateralized Fund Obligations) is currently being addressed by the SAPWG and we suggest that topic is substantive and should be expanded to include the recommended referral from the SVO.

Affiliate/related party transactions: The SVO indicated that the source of the assets being transferred into principal protected notes and their relationship to the insurer is not transparent. As part of the recommendation, the SVO would alert regulators to the extent that the SVO identified possible affiliated assets. SSAP 25 and SSAP 103R both have measurement and disclosure requirements. We are supportive of improved quality of disclosures providing transparency into affiliated and related party transactions and ongoing exposures to the same. We expect this could be accomplished through other regulatory clarifications that do not require the SVO to assign designations.

SVO stated analytical concern: We appreciate the analytical concern that there may be risks being obscured in these structures. However, we do not fully understand how this concern is addressed by the SVO recommendation. Mostly, this stems from a lack of clear definition of the assets to which the proposal would be applied. We are concerned that the definition laid out in the SVO proposal differs from industry standard definitions found on Bloomberg or other reputable sources. The result may be inconsistent application across the industry.

Implementation and timing: We are concerned about the pace in which it appears this topic is to be implemented. In addition to the potential impact to RBC, a shift in the rules may impact surplus due to an adverse change to market pricing on impacted investments should companies desire to transact in order to exit positions. In the past, substantive changes to the regulatory framework have been studied to understand their impact prior to adoption of any recommended change. We request similar application in this matter, being mindful of unintended scope expansion to additional investments. In order to complete such a study effectively, we assert that the SVO must clearly articulate the nature of the analysis and the expected outcome on the affected investments.

We understand the SVO has no interest in grandfathering current investments. We agree that such grandfathering would be inappropriate. Instead, we suggest that the SVO provide transparency on how they would assign designations to affected investments and allow a reasonable transition period for affected companies to manage the potential impacts to investments that were acquired in accordance with and under a previous set of regulatory standards.

What seems imperative to a healthy regulatory environment and the financial stability of individual companies is a more deliberative and transparent approach to this issue. We look forward to continuing work with the SVO and the Task Force to achieve regulatory objectives in support of a healthy insurance industry.

Best regards,



Ellyn M. Nettleton
Controller and Treasurer



Bradley Anderson
Investment Valuation and Analysis

September 19, 2019

VIA EMAIL

Mr. Kevin Fry
Chairman, Valuation of Securities (E) Task Force,
National Association of Insurance Commissioners
and
Chief Operating Officer
Illinois Department of Insurance
320 West Washington Street, Fourth Floor
Springfield, IL 62767

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC
Investment Analysis Office (the "P&P Manual") to update the Definition and
Instructions for Principal Protected Notes ("PPNs")

Dear Chairman Fry and Members of the Valuation of Securities (E) Task Force:

Kroll Bond Rating Agency, Inc. ("KBRA") thanks you for the opportunity to submit this letter during the open comment period concerning the proposal to amend the P&P Manual's definition of PPNs and the instructions for reporting PPNs (the "Proposal"). KBRA generally supports the Task Force's objective of properly understanding and evaluating the risk of securities that are held by regulated insurance companies. KBRA also has reviewed the Securities Valuation Office's July 2, 2019 memorandum regarding the Proposal (the "Memo"). Given that KBRA and the Task Force share the goal of accurately assessing risk, KBRA's purpose in submitting this letter is to clarify KBRA's understanding as to certain matters of fact set forth in the Memo.

KBRA believes that a security is not necessarily more or less risky solely because the security features a PPN in its structure. The main question should be: are the cash flows generated by the collateral supporting a debt instrument capable of meeting the principal and interest payment obligations of the transaction? For example, there may be transactions structured with PPNs where the collateral consists solely of AAA rated U.S. Treasury Bonds. Instead of evaluating the actual risk associated with the collateral, the Proposal would treat such a transaction the same way it would treat one that incorporates a PPN secured solely by non-investment grade securities. Conversely, a debt transaction that is secured by those same non-investment grade securities, but which does not include a PPN in its structure, would not be excluded by the PPN prohibition articulated in the Proposal. Whether a structure includes a PPN is important, but it should be a secondary consideration that should be incorporated into an

Mr. Kevin Fry
Chairman, Valuation of Securities (E) Task Force,
National Association of Insurance Commissioners
September 19, 2019
Page 2 of 3

analysis of the structural risks of any transaction. In short, KBRA does not believe that PPNs are inherently risky.

KBRA believes that analyzing risk must include, but should not be limited to, a transaction's structural features. More importantly, KBRA believes that all risks, including collateral and structural features, should be analyzed together in order to properly assess risk. KBRA welcomes the opportunity to participate in more conversations around these issues.

Sincerely,



Jim Nadler
Chief Executive Officer and President
Kroll Bond Rating Agency, Inc.



Patrick Welch
Chief Credit Officer
Kroll Bond Rating Agency, Inc.

cc: Mr. Charles Therriault
Director, Securities Valuation Office
National Association of Insurance Commissioners (via email)

Ms. Denise Genao-Rosado
Senior Administrative Assistant
National Association of Insurance Commissioners (via email)



Mike Monahan
Senior Director, Accounting



Tracey Lindsey
President

September 20, 2019

Mr. Kevin Fry, Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Mr. Stewart Guerin, Vice Chair
NAIC Valuation of Securities (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64016-2197

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to update the Definition and Instructions for Principal Protected Notes

Dear Messrs. Fry and Guerin:

ACLI¹ and NASVA² (“the undersigned”) appreciate the opportunity to provide feedback on the Valuation of Securities Task Force (“the Task Force”) exposure regarding ‘Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to update the Definition and Instructions for Principal Protected Notes’ (“the exposure”). Although we agree with the Analytical Concern stated in the exposure, as it relates to the example securities provided, we have three potential concerns: Securities Valuation Office (“SVO”) Capacity to Designate, Unintended Scope Expansion and Prospective Application. We will address each of these concerns below in greater detail.

SVO Capacity to Designate

We note the SVO has taken on various additional designation responsibilities and we have some concerns on whether the SVO has the capacity to designate further securities. There are also concerns that the SVO may not yet have an established and vetted rating methodology developed for the unique Analytical Concern presented by Principal Protected Notes (“PPNs”). Furthermore, given the nuances of existing standards regarding SVO authority to evaluate different types of structured securities, not to mention

¹ The **American Council of Life Insurers** (ACLI) advocates on behalf of 280 member companies dedicated to providing products and services that promote consumers’ financial and retirement security. 90 million American families depend on our members for life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, dental and vision and other supplemental benefits. ACLI represents member companies in state, federal and international forums for public policy that supports the industry marketplace and the families that rely on life insurers’ products for peace of mind. ACLI members represent 95 percent of industry assets in the United States. Learn more at www.acli.com.

² The **North American Securities Valuation Association** (NASVA) is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office 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.

additional possible components of PPNs (commodities, derivatives, equities, etc.), the absence of greater elaboration on the proposed methodology for PPNs concerns some of our membership. Our ask is that these issues are thoroughly vetted prior to adopting any further guidance related to PPNs.

It would be helpful if the major tenets of the rating methodology that will be used (or developed) to designate such securities could be shared with industry, including the extent to which approved credit rating provider (CRP) ratings will be considered. Structured finance assets provide insurance companies access to solid risk adjusted returns at a time when higher yields are scarce, and to cash flows streams that are often well suited to our asset/liability matching (“ALM”) needs. Given the potential implications for insurance companies weighing risk adjusted return opportunities that will support the ability to meet future policy holder obligations, we believe additional insight into the designation process will help provide clarity for insurers and minimize market uncertainty.

Unintended Scope Expansion

The exposure states:

These additional assets are intended to generate an excess return, we call them the “performance assets,” such as, derivatives, common stock, commodities, equity indices, etc. ... essentially any asset. The performance assets may include undisclosed assets and are typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond.

The SVO has reviewed a dozen or more of these securities. They share a consistent theme; the external credit rating provider (CRP) rating is based solely on the component dedicated to the repayment of principal and ignores the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1.

In both examples, assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that schedule through financial structuring. Significant risks are being obscured by focusing only risk associated with the repayment of principal.

The exposure appears focused on the primary concern that external CRP ratings do not always fully depict the risks inherent to PPN investments. In such instances, the concern may arise that use of such CRP ratings under the Filing Exempt process would allow the investments to appear on Schedule D, Part 1 as structured securities, providing the impression to financial statement users that the investment risks are confined to the credit risk implied by the CRP rating. Absent contractual overlays that transform the risks to invested basis into solely those relating to the capacity of the obligor to make contractually promised payments, a portion of the carry value presented as a fixed-income like investment with a particular credit profile in the statutory financial statements could be exposed to the types of risks that would garner different classification and measurement/valuation under the applicable statutory guidance (e.g., risks associated with non-Schedule D, Part 1 eligible asset classes such as derivatives, equities, commodities, etc.). Viewed through this lens, we do not take issue with the elaborative language identifying concern that, in such instances, the CRP rating’s focus on only one of several inherent risks could fail to meet the regulatory objective.

However, the literal language drafted as the proposed amendment appears to expand beyond the objective of gaining additional visibility into the risks inherent to PPN investments. Mindful of unintended scope expansion, we feel the definition of PPNs within the proposed amendments should be updated to focus on characteristics indicating heightened risk that the security’s CRP rating is based solely on the underlying asset component dedicated to the repayment of principal and interest, and ignores the risk associated with the underlying performance assets. This appears to be a primary concern targeted by the exposure. We would like to offer a revised definition to dispel potential ambiguities as to the scope of the proposed amendments and facilitate consistent application across reporting entities:

Principal Protected Notes (PPNs) – are a type of structured security where payment of contractually promised fixed cash flows (principal and interest thereon) is satisfied by an underlying approved CRP rated bond(s), but additional potential returns are generated by additional assets in the structure which do not contribute to the contractually promised fixed cash flows. Investments in PPNs must be submitted to the SVO for analysis.

The type of performance asset underlying a PPN (as defined above) may vary, as the distinguishing characteristic of a PPN is that only a portion of the underlying assets are dedicated to the satisfaction of contractually promised fixed cash flows – indicating heightened risk that the security’s CRP rating fails to fully depict risks inherent to the structure as a whole. The above definition would capture both examples provided in the body of the exposure and achieve the regulatory objective with reduced potential for unintended expansion of scope or inconsistent application across reporting entities. If there are analytical concerns which do not meet the above definition, we request dialogue with the SVO to address each concern, on an iterative basis, to ensure the definition is not overly broad while still meeting regulatory objectives. In that same spirit, we would like additional dialogue to ensure that structures not containing the above defined characteristics– e.g., structures containing derivatives only hedging foreign exchange risk, tranches in CLO structures, etc. - are not captured within the scope of the PPN definition.

Prospective Application

We believe the new filing requirements for PPNs should be applied prospectively. While industry is sympathetic to the Analytical Concern related to PPNs, we are concerned about establishing a precedent of retroactive rule changes, particularly as it relates to filing requirements. Investments by insurance companies prior to the implementation of this change were made under a reasonable belief that then existing filing instructions were representative of statutory standards applicable for PPNs.

We look forward to continuing work with the SVO and the Task Force to right-size this proposal to help achieve regulatory objectives but also to ensure it does not portend any unnecessary burdens for reporting companies or unintended consequences. Further, the filing exempt process has served both industry and regulators well over the past decades. We want to ensure this process is utilized to the best extent possible, understanding that the SVO does not have the capacity to assign designations for the entire population of Schedule D, Part 1 eligible securities.

Please do not hesitate to contact us should you have any questions. Thank you.

Sincerely,



Senior Director, Accounting Policy
American Council of Life Insurers

Tracey Lindsey

President
North American Securities Valuation Association

cc: Mr. Charles Therriault, Director, SVO