Attachment S

National Association *of* Insurance Commissioners

The CENTER *for* INSURANCE POLICY *and* RESEARCH

To: Draft Referral Response to the Valuation of Securities (E) Task Force

From: Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group

Re: Referral Response – Regulatory Issues in Debt / Preferred Stock of SCAs for SVO Methodology

Date: July 17, 2017

This memo responds to the Valuation of Securities (E) Task Force April 18, 2017 referral requesting assistance in formulating additional procedures / limitations for assignment of NAIC designations to investments in an insurance entity's subsidiary, controlled or affiliated (SCA) entity. The Task Force referral identifies that such assistance from the Statutory Accounting Principles (E) Working Group would enable the SVO to formulate a methodology that merges analytical and regulatory criteria for consideration by the Task Force. Furthermore, the referral requests differentiation between SCA investments that resemble unaffiliated investments and those that are unique transactions designed to accommodate intercompany issues.

After reviewing the existing SVO additional special assessment procedures to review debt or preferred stock transactions involving SCAs shown in part three section 2 of the *Purposes and Procedures Manual of the NAIC Investment Analysis Offic*e, **the Working Group recommends revisions (detailed in Appendix A), to the SVO procedures in issuing NAIC designations for these securities. As part of these revisions, the Working Group recommends clarification that an NAIC designation, or a CRP rating, only reflects a credit assessment, and does not consider collectibility based on independent payment ability, does not reflect whether a transaction was conducted as arms-length, and does not reflect whether a transaction is considered economic under SSAP No. 25.** The Working Group highlights that the assessment of these affiliate components requires a detailed review of the transaction between the reporting entity and the SCA, and such assessments are beyond the scope of an SVO credit assessment and likely a required filing in a company's state of domicile

Consistent with existing SVO filing procedures, if an NAIC designation is required for an investment, and the investment does not have a qualifying CRP rating, then it shall be submitted to the NAIC SVO for a credit assessment under the standard SVO credit-assessment process. As detailed in the proposed revisions, it is recommended that the NAIC SVO clarify that under their procedures, the SVO will review affiliated transactions that resemble straightforward, unaffiliated investments in the same manner as unaffiliated transactions. Determination of NAIC designations on complicated, unique transactions will be subject to SVO filing procedures on whether a credit-assessment can be provided. Revisions to the proposed procedures also indicate that if the SVO becomes aware of any information that indicates further review is warranted, the SVO shall contact the reporting entity to discuss the transaction, with subsequent notification provided to the domiciliary state regulator, as needed. Pursuant to SSAP No. 25, affiliate transactions that are not arm's-length and/or economic are subject to additional accounting and reporting guidelines and each reporting entity is required to be knowledgeable about its domiciliary state regulator requirements for approval of these transactions.

The Working Group reiterates that the issuance of any NAIC designation (including NAIC 1), or the non-issuance of an NAIC designation (such as with complex, multiple affiliate transactions) does not provide indication on whether the investment qualifies for admittance under SSAP No. 25. Pursuant to SSAP No. 25, the admittance assessment would continue to be dependent on the review of the domiciliary state and/or management evaluations. With this referral to the Task Force, the Working Group will also be assessing whether enhanced guidance should be considered to strengthen the principles involving related-party transactions, and the requirements for management / auditors to review and assess related-party transactions, as well as whether additional disclosures or reporting information is needed. Please contact NAIC staff of the Statutory Accounting Principles (E) Working Group if you have any questions.

Cc: Julie Gann/Robin Marcotte/ Fatima Sediqzad/Jake Stultz/Charles A. Therriault/Robert Carcano

Statutory Accounting Principles (E) Working Group
Proposed Revisions to the Purposes and Procedures Manual of the NAIC Investment Analysis Office.

Part Three – Credit Assessment

Section 2. Corporate Bonds and Preferred Stock – Special Assessment Situations

Bonds and preferred stock that fit the description set out below shall be subject to the general procedures specified above as well as the specific or special procedures identified below.

d) SCA Debt and Preferred Stock

This section applies to credit assessment[1] of any SCA investment in the form of a debt instrument purchased (or otherwise acquired) from an insurance or non-insurance entity (SCA debt) and preferred stock issued by an insurance or non-insurance ~~non-insurer~~ entity (SCA preferred stock). This procedure is used to determine whether an SCA debt or SCA preferred transaction is eligible for reporting as an Investment Security pursuant to Part Two Section 2 (a) of this Manual. The determination of "Investment Security" and credit assessment (either obtained from the NAIC SVO or if the security is filing exempt with a credit rating from a CRP) shall not be construed to reflect assessments specific to affiliated transactions contained in *SSAP No. 25—Affiliates and Other Related Parties*. As such, a CRP rating or NAIC SVO designation for affiliated transactions:

- Does not reflect collectability based on independent payment ability of a parent reporting entity.
- Does not reflect whether the transaction was conducted at arm's-length.
- Does not reflect whether the transaction is considered "economic" under SSAP No. 25.

(i) Procedure

Prior to applying the procedures required by Part Five, Section 2 of this Manual, the SVO shall:

(A) Confirm that the SCA relationship has been reported to the NAIC Financial Reporting Services Division, if required.

(B) If the SCA common / preferred stock transaction was reported (or if not required to be reported), the SVO shall:

(1) Inform the state insurance department of the reporting insurance company's state of domicile that the SCA debt or SCA preferred stock has been filed with the SVO.

(~~3~~2)~~Evaluate whether the SCA debt or SCA preferred stock is an arms-length and an economic transaction within the meaning of NAIC statutory accounting guidance on related party transactions.~~

(~~4~~3)Evaluate whether the SCA debt or SCA preferred stock transaction is circular within the meaning of Part One, Section 2(c)(ii) of this Manual.

(~~5~~4)In the case of SCA preferred stock, determine the SCA preferred stock issuer's senior unsecured debt designation and obtain the appropriate designation level for the preferred stock by applying the methodology specified in Section 1(b) of this Part above.

[1] Consistent with guidance in Part One, Section Two, the result of an SVO credit analysis expresses an opinion of the credit quality of a specific liability in the issuer's capital structure. The ability to realize payment may be affected by factors not related to credit risk, or by the manner in which the repayment promise has been structured. NAIC designations do not measure other risks or factors that may affect repayment, including volatility/interest rate, prepayment, extension or liquidity, and for affiliated transactions addressed in this section, whether the transaction is considered arms-length and economic.

Although an NAIC designation (or CRP rating) does not provide assurances regarding arms-length or economic, if the SVO becomes aware of any information that indicates further review is warranted, the SVO shall contact the reporting entity to discuss, with subsequent notification (by the reporting entity or SVO) to the domiciliary state regulator, as needed. Pursuant to SSAP No. 25, affiliate transactions that are not arm's-length and/or economic are subject to additional accounting and reporting guidelines and each reporting entity is required to be knowledgeable about its domiciliary state regulatory requirements for approval of these transactions.

The following definitions / concepts are from SSAP No. 25:

- Arm's-Length: An arm's-length transaction is defined as a transaction in which willing parties, each being reasonably aware of all relevant facts and neither under compulsion to buy, sell, or loan, would be willing to participate.

- Economic: An economic transaction is defined as an arm's-length transaction which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof, i.e., "permanence." The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. An economic transaction must represent a bonafide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance, not the form of the transaction.