



MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office

CC: Charles Therriault, Director, NAIC Securities Valuation Office
Winnie Cheng, Manager, NAIC Securities Valuation Office
Julie Gann, Senior Manager NAIC, Financial Regulatory Services

DATE: May 16, 2017

RE: Staff Report on Errors Made in Placing Mutual Funds on the U.S. Direct Obligations/Full Faith and Credit Exempt List (List) and Proposals to Address the Errors

1. Issue – The Securities Valuation Office (SVO) added approximately 40 funds to the List that do not qualify to be on it. The added funds invest in obligations of government sponsored enterprises (GSOs) as defined in Part Two, Section 4 (c) (ii) of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). The List is limited to funds that invest 100% of total assets in direct and full faith and credit obligations of the U.S. government or collateralized repurchase agreements comprised of such obligations at all times. The SVO has established that insurer investment in the added funds is approximately \$6 billion dollars. Although the SVO can reverse the errors by not renewing the non-compliant funds, the SVO recommends that the Task Force consider expanding the List to include the issuers/securities identified in Part Two, Section 4 (c) (ii) of the P&P Manual. Attachment One reproduces the sections of the P&P Manual discussed in this memorandum.

2. Revising the List

a. Existing Policy – The recommendation that the current List be expanded reflects the NAIC reporting framework, filing exemption for U.S. obligations and policy determination discussed in Part Six, Section 2 (e) and Part Two, Section 4 (c) (i) and 4 (c) (ii) of the P&P Manual. Although the issuers/securities in Section 4 (c) (i) are “exempt obligations” and those in Section 4 (c) (ii) are not, the securities in Section 4 (c) (ii) “ ... issued and either guaranteed or insured, as to the timely payment of principal and interest, by the [identified] government agencies or government-sponsored enterprises are filing exempt, (... despite the fact that they are ...) not backed by the full faith and credit of the U.S. Government” because the NAIC has determined “ ... that [such issuers] will be able to pay its obligation on a full and timely basis at the level of an **NAIC 1** quality designation.” (Emphasis added).

b. Application of Policy – The Task Force can recognize the higher credit quality of issuers/securities identified in Section 4 (c) (ii) relative to private issuers/securities by expanding the current List to include money market mutual funds that invest in Section 4 (c) (i) and in 4 (c) (ii) issuers/securities.

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c. **Reporting Money Market Mutual Funds** – Effective year-end 2017, exempt and non-exempt money market mutual funds are reported as cash equivalents without an NAIC Designation on Schedule E-2 at net asset value (NAV)/fair value. An exempt money market fund is assigned a risk-based capital (RBC) of zero.

d. **Other Considerations** – Funds that invest in Section 4 (c) (ii) issuers/securities are also government money market mutual funds under U.S. Securities and Exchange Commission (SEC) Rule 2a7 and meet the same quality, maturity, diversification and liquidity standards that the funds on the List meet;¹ seek to maintain a stable NAV of \$1.00 per share; and offer redemption in seven days. We anticipate that the investment objective of funds that invest in a high percentage of Section 4 (c) (ii) issuers/securities would be to provide current income consistent with safety of principal and liquidity and that the fund would likely invest at least 80%, and normally substantially all, of its net assets in marketable obligations issued or guaranteed by the Section 4 (c) (ii) issuers/securities and repurchase agreements related to such securities.

3. **Proposed Amendment to the P&P Manual to Add a Verification Procedure** – If the Task Force wished to implement the recommended change in the List, the following amendments to the P&P Manual are proposed:

Part Six - SVO Verification Activities In Support Of Certain Regulatory Processes

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Section 2. Mutual Funds and Exchange Traded Funds

b) Mutual Fund Lists

(i) U.S. Direct Obligations/Full Faith and Credit Exempt List

A money market fund is eligible for listing on the U.S. Direct Obligations/Full Faith and Credit Exempt List if the fund meets the following conditions:

(A) The fund maintains a money market fund rating of AAAM from Standard & Poor's or Aaa-mf from Moody's Investor Services or an equivalent money market fund rating from any NAIC CRP.

(B) The fund maintains a stable net asset value per share of \$1.00.

(C) The fund allows a maximum of seven-day redemption of proceeds.

(D) The fund invests 100% of its total assets in securities that are direct obligations of the United States Government and/or in securities that are backed by the full faith and credit of the United States Government or collateralized repurchase agreements comprised of such obligations at all times. Refer to Section 2(e) below for a list of securities considered to be direct obligations of the United States Government and entities that are entitled to the full faith and credit of the United States Government.

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¹ Rule 2a-7 requires portfolio investments to have: (i) a remaining maturity of no more than 397 days (subject to other provisions of the Rule); (ii) a weighted average maturity not to exceed 60 days; and (iii) a weighted average life not to exceed 120 days. Rule 2a-7 imposes liquidity standards that require a portfolio to hold at least 10% and 30% of its total assets in daily liquid assets and weekly liquid assets, respectively, as defined in the Rule. Rule 2a-7 also limits portfolio's investments in illiquid securities to 5% of total assets.

Attachment One

Sections of the P&P Manual Relevant to Determining when a Money Market Fund Meets Requirements for Listing

Part Six - SVO Verification Activities In Support Of Certain Regulatory Processes

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Section 2. Mutual Funds and Exchange Traded Funds

a) SVO Administration

As set forth in Part Two, Section 9(e) of this Manual, the SVO is charged with verifying whether a money market fund is eligible to be listed on the U.S. Direct Obligations/Full Faith and Credit Exempt List or the Class 1 List, and whether a bond mutual fund is eligible to be listed on the Bond List. Eligibility requirements for the aforementioned lists are described below and apply notwithstanding the definition of the term “short-term investment” set forth elsewhere in this Manual.

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(e) List of Securities that are Considered “Exempt Obligations” for Purposes of Determining the Asset Valuation Reserve and the Risk-Based Capital Calculation

THIS SECTION IS USED TO DETERMINE THOSE SECURITIES THAT ARE INCLUDED IN THE "EXEMPT OBLIGATIONS" CATEGORY FOR PURPOSES OF DETERMINING ASSET VALUATION RESERVE AND THE RISK-BASED CAPITAL CALCULATION.

The securities issued, guaranteed or insured by entities shown in [Part Two, Section 4 \(c\) \(i\)](#) are considered to be in the “exempt obligations” category for purposes of determining Asset Valuation Reserve and the Risk-Based Capital charge calculation.

Securities issued, guaranteed or insured by entities on the Filing Exempt Other U.S. Government list are not “exempt obligations”, and shall be reported in the Special Revenue and Special Assessment Obligations category, not in the U.S. Government category.

The loan-backed and structured securities that are “exempt obligations” and are reported in the U.S. Government category are securities that have a full guarantee for their interest and principal payments by the United States Government. Examples are the pass through securities and Collateralized Mortgage Obligations guaranteed by the Government National Mortgage Association (GNMA) or the U.S. Department of Veterans Affairs (VA).

Part Two Filing with the SVO

Section 4. Reporting Exceptions

(c) U.S. Government Securities

This section defines what the NAIC deems to be U.S. Government Obligations. They are not required to be filed with the SVO.

NOTE: Because these filing exemption provisions are set forth without any compliance mechanism, the SVO will not be able to verify whether insurers have filed all securities that are required to be filed with the SVO. State insurance department regulators may wish to create their own compliance mechanisms to protect any interests they may have relative to their domiciliary insurers.

The SVO does not have responsibility for determining whether specific securities should be filing exempt. An insurer who is uncertain whether a specific security qualifies for exemption should not contact the SVO for guidance, but should either file the security with the SVO or use the [EIV Regulatory Treatment Analysis Service](#) process described in [Part Four, Section 3 of this Manual](#) and obtain an opinion on exemption for that security.

(i) Filing Exemption for Direct Claims on, or Backed Full Faith and Credit of, the United States

U.S. Government Obligations means all direct claims (including securities, loans, and leases) on, and the portions of claims that are directly and unconditionally issued, **guaranteed or insured** by the United States Government or its agencies.

U.S. Government agency means an **instrumentality** of the U.S. Government the debt Obligations of which are fully guaranteed or insured as to the timely payment of principal and interest by the full faith and credit of the U.S. Government. This category includes in addition to direct claims on, and the portions of claims that are directly and unconditionally guaranteed by, the United States Government agencies listed below, claims collateralized by securities issued or guaranteed by the U.S. government agencies listed below for which a positive margin of collateral is maintained on a daily basis, fully taking into account any change in the insurance company's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim.

U.S. Government Full Faith and Credit – Filing Exempt
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Agency for International Development (AID)
Army and Air Force Exchange Services (AAFS)
Commodity Credit Corporation (CCC)
Export – Import Bank of the United States (Exim Bank)
Farmers Home Administration (FmHA) Certificates of Beneficial Ownership
Federal Deposit Insurance Corporation (FDIC)
Federal Housing Administration (FHA)
General Services Administration (GSA)
Government National Mortgage Association (GNMA)
Health and Human Services (HHS)
Housing and Urban Development (HUD)
Maritime Administration (MARAD)
National Credit Union Administration (NCUA)
Overseas Private Investment Corp (OPIC)
Small Business Administration (SBA)
United States Department of Agriculture (USDA)
United States Treasury
Veterans Administration (VA)
Washington Metropolitan Area Transit Authority

(ii) Filing Exemption for other U.S. Government Obligations

Obligations issued and either guaranteed or insured, as to the timely payment of principal and interest, by the government agencies or government-sponsored enterprises listed below are filing exempt. They are not backed by the full faith and credit of the U.S. Government. The filing exemption here is based on an analytical judgment that the combined creditworthiness of the entity itself and U.S. government support for that entity provides confidence that the issuer will be able to pay its obligation on a full and timely basis at the level of an NAIC 1 quality designation. For the avoidance of doubt, preferred stock or similar securities of the government agencies or government-sponsored enterprises listed below are not considered guaranteed or insured and hence are not subject of this section (ii).

Filing Exempt Other U.S. Government Obligations if issued and either fully guaranteed or insured by:

Federal Agricultural Mortgage Corporation (Farmer Mac)
Federal Farm Credit Banks (FFCB)
Federal Financing Bank (FFB)
Federal Home Loan Banks (FHLB)
Federal Home Loan Mortgage Corporation (Freddie Mac)
Federal National Mortgage Association (Fannie Mae)
Financing Corporation (FICO)
Resolution Funding Corporation (REFCorp)
Tennessee Valley Authority (TVA)