Statutory Accounting Principles (E) Working Group
Meeting Agenda
May 20, 2021

A. Consideration of Maintenance Agenda – Active List

1. Ref #2019-21: SSAP No. 43R

Ref #	Title	Attachment #
2019-21 SSAP No. 26R SSAP No. 43R	**SSAP No. 43R**	**A – Proposed Bond Definition**

Summary:
In 2013, the Working Group began the "Investment Classification Project" with the intent to undertake a comprehensive project to review the investment SSAPs to clarify definitions, scope, and the accounting method / related reporting. This substantive project specifically noted an intent to consider investments that were outside of "investment-type" definitions and consider characteristics to ensure appropriate valuation and reporting. Since origination of the project, the SAPWG has adopted substantive revisions to *SSAP No. 26R—Bonds, SSAP No. 30R—Common Stock* and *SSAP No. 32R—Preferred Stock.* Discussion of *SSAP No. 43R—Loan-Backed and Structured Securities* began in 2019 with a specific focus of underlying equity investments. Since then, the discussion expanded to be a complete review of the SSAP under the investment classification project and thus far has consisted of the following:

- August 2019: Exposed proposed revisions to exclude collateralized fund obligations (CFOs) and similar structures that reflect underlying equity interests from SSAP No. 43R, as well as prevent equity assets from being repackaged as securitizations and reported as long-term bonds.

- January 2020: Directed comprehensive project and the development of an issue paper to consider revisions to SSAP No. 43R.

- March 2020: Exposed preliminary issue paper for assessment. This issue paper introduced potential options to consider when assessing substantive revisions, focusing on different types of investments based on their characteristics. It began with an initial assessment of "asset-backed securities" under the Code of Federal Regulations (CFR) and items that would not fit within that definition.

- October 2020: Conducted hearing to receive industry comments on the exposed issue paper. Industry comments focused on two main themes: 1) Classification between 26R and 43R and 2) Definition of Asset Backed Security (ABS). After the discussion, Iowa proposed stepping back from the 26R vs 43R discussion with a more holistic principles-based approach to define a bond eligible for reporting on *Schedule D-1: Long-Term Bonds* (whether 26R or 43R). With this recommendation, the Working Group exposed draft principles for a bond definition as a starting point.

- Since the Fall of 2020, a small group comprised of Iowa, NAIC staff and Industry Reps have been meeting weekly to develop a draft bond proposal for consideration.

The small 43R group has developed a proposed definition to be used for all securities in determining whether they qualify for reporting on Schedule D-1. This proposed definition intends to reflect principle concepts, that focus on substance over form, to ensure appropriate consideration on whether a structure qualifies as an issuer credit obligation or asset-backed security prior to reporting as a bond.

Key aspects of the proposed definition:

- A bond represents a credit relationship in substance, not just legal form.
    - Investments with equity-like characteristics or that represent ownership interests in substance, are not bonds.
    - Includes a rebuttable presumption that investments which rely on equity return cash flows are not bonds. The presumption may only be overcome through documented analysis supporting the recharacterization of the underlying equity risks into bond risk through structuring and diversification of collateral. This allows certain investments (such as collateralized fund obligations) that have appropriate structuring and collateral to be reported as bonds, only if properly supported by analysis.
- Bonds are either issuer obligations or asset-backed securities (ABS).
    - Issuer obligations are supported primarily by the general creditworthiness of an operating entity or entities. Examples of issuer obligations have been expanded to include project finance bonds issued by operating entities, bonds issued by REITs or similar property trusts, bonds issued by closed-end funds and other operating entities registered under the 1940 Act, and equipment trust certificates (ETCs), EETCs and credit tenant loans (CTLs) when payment is fully supported by a lease to an operating entity.
    - ABS are issued by entities that have a primary purpose of raising debt capital backed by collateral that provides the cash flows to service the debt. Although typically issued by special purpose entities (SPVs). An SPV is not a necessary component in classifying as an ABS. ABS shall be backed by either financial assets or cash-generating non-financial assets.
        - SSAP 103R defines a financial asset as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right (a) to receive cash or another financial instrument from a second entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity. Per the bond definition, financial assets do not include assets for which the realization of the benefits depends on the completion of a performance obligation (e.g., leases, mortgage servicing rights, royalty rights, etc.). These assets represent non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied.
    - To qualify as a bond, an ABS must put the investment holder in a different economic position than owning the collateral directly. This is a requirement for all ABS regardless of the collateral backing the investment. This is accomplished through sufficient credit enhancement (process to absorb losses), overcollateralization, or other forms of guarantees or recourse.
    - To qualify as a bond, cash-generating non-financial assets backing ABS shall be expected to generate a meaningful source of cash flows for repayment of the bond, other than through the sale or refinancing of the assets. (The nature of the non-financial assets must lend itself to the production of fixed-income-like cash flows.)
    - Determination of sufficient credit enhancement and meaningful cash flows are determined at origination and are the responsibility of the insurer reporting entity. Documentation of the analysis shall be maintained and provided to regulators / auditors to support bond determination. Examples to assess sufficiency and meaningful are included in the proposed definition.

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- The principle concepts included in the proposed definition are intended to apply to all investments subject for inclusion on D-1. As such, specific consideration for certain investments (such as CTLs) may no longer be applicable. As detailed in the proposed definition, CTLs fully supported by a current lease would be considered an issuer obligation. CTLs that have residual risk (not fully supported) would be subject to the ABS provisions of sufficiency and meaningful.

Although the proposed definition includes the principle concepts for the bond definition, discussions and developments are still required on the following aspects:

- Proposal to improve transparency and reporting for Schedule D-1 items. This is planned to revise the existing reporting lines / categories and include more granular / descriptive reporting lines as well as a potential sub-schedule to identify items that have underlying equity risk or that do not self-liquidate. (Discussions on this item by the small group is expected to begin during the definition's exposure period.)

- Inclusion of actual revisions to the SSAPs to incorporate the bond definition as well as the development and adoption of an issue paper to document the discussions and revisions in developing the bond definition. (This work is not anticipated until after the proposed bond definition has been exposed and comments have been considered.)

- Development of accounting and reporting guidance for investments that do not fit the scope of *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* and that do not qualify under the bond definition. The current reporting guidance on Schedule BA only permits SSAP No. 48 items and private equity items to have NAIC designations for RBC impact. Additionally, the guidance in SSAP No. 48 requires audited financial statements for admittance and this provision may not be applicable for investments that may be captured on BA as they do not meet the principles for bond reporting.

- Consideration of transition guidance. It should be clearly noted that wide-spread grandfather provisions are not expected. As such, investments that have previously been reported as bonds may be required to move to BA (or another schedule) in accordance with the bond definition. However, consideration is expected on how to assess existing investments in determining whether they qualify for bond reporting at transition. It is recognized that assessing investments per historical origination date information may not be feasible.

Recommendation:
NAIC staff recommends that the Working Group expose the proposed bond definition for a public comment period ending July 15, 2021.

The focus of this exposure is specific to the proposed bond definition, but comments on future developments (such as reporting changes on Schedule D-1, development of accounting and reporting guidance for items that do not qualify for bond reporting, transition guidance, etc.) may also be submitted to assist in the development of these items.

ANY OTHER MATTERS

a. Life Risk-Based Capital (E) Working Group – Referral (Julie) (Attachment B) & Draft Response (Attachment C - Pending)

On April 26, 2021, the Life Risk-Based Capital (E) Working Group sent a referral to SAPWG requesting consideration on the accounting and reporting aspects of an American Council of Life Insurers (ACLI) proposal to modify the treatment of real estate in the life RBC formula. Per the referral, one aspect included is the incorporation of an adjustment to the factor applied based, in part, on the fair value of real estate reported in the annual statement. This proposal requests this treatment for real estate reported on Schedule A: Real Estate and for items captured as "Joint Venture, Partnership, or Limited Liability Company Investments with

the Underlying Characteristics of Real Estate" (reporting lines 219999 and 229999 on Schedule BA).

After considering the use of fair value on these Schedules (which has historically only been used to support BACV from an OTTI), the inconsistent reporting of fair value on Schedule A and BA and the limited appraisal requirements in *SSAP No. 40—Real Estate Investments*, a draft response has been prepared to note comments and concerns with this proposal based on accounting and reporting provisions. This response highlights that using reported fair value to reduce RBC creates a situation that is susceptible for RBC optimization.

b. Credit Tenant Loans – VOSTF Referral Response & INT 20-10 Update (Julie) (Attachment D)

On Jan. 22, 2021, the Working Group provided a referral to the Valuation of Securities (E) Task Force pursuant to the discussion and direction that occurred in 2020 regarding credit tenant loans (CTLs). This referral requested the Task Force to provide comments on the following:

- Whether it is appropriate to revisit the 5% residual asset risk threshold as a restriction for conforming CTLs. If applicable, a recommendation of an appropriate residual risk threshold.
- Whether other mechanisms or compensating controls (beyond a residual risk insurance policy) could be incorporated as a mitigating factor for CTLs that exceed the 5% residual risk threshold (or a threshold as recommended).
- A listing of the nonconforming CTLs that were filed with the SVO in accordance with the direction of Interpretation (INT) 20-10. Please include high level details including outstanding principal and NAIC designation assigned by the SVO.
- To the extent possible using best efforts, on 1) how many CTLs originally exceeded the residual risk threshold but were later considered as "conforming" due to mitigating factors, and 2) the nature of those factors (i.e., a residual risk insurance policy).

The Task Force provided a detailed response to this referral on May 1, 2021.

In addition to the public information, a regulator-only addendum was provided to detail the nonconforming CTLs that were filed with the SVO in accordance with INT 20-10. Since this is investment specific data, and could be utilized to identify holdings at insurers, this information has been provided as a regulator-only memorandum.

As the referral response was just recently received, NAIC staff will be reviewing the response and discussing next steps regarding to CTLs with the Working Group. Further discussion is expected during the interim or the Summer National Meeting.

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Statutory Accounting Principles (E) Working Group
Proposed Bond Definition
May 20, 2021

Introduction: Pursuant to the direction from the Statutory Accounting Principles (E) Working Group in October 2020, a small group of regulators and industry have been meeting regularly to draft a bond definition for consideration. The intent of this project is to clarify what should be considered a bond (whether captured in *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities*) and reported on Schedule D-1: Long-Term Bonds. **This exposure is specific to the proposed bond definition below, along with the glossary (page 5) and appendices (pages 6-12)**, but comments on future developments (such as reporting changes, accounting and reporting guidance for items that do not qualify as bonds, transition guidance, etc.) may also be submitted to assist in the development of these items.

Below is the proposed principles-based definition of a bond eligible for reporting on Schedule D, Part 1.

1. A bond shall be defined as any security[1] representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset backed security.

   [Need to incorporate concepts of paragraph 2 of current SSAP No. 26R but not recast here for brevity]

   Determining whether a security represents a creditor relationship should consider its substance, rather than solely the legal form of the instrument. The analysis of whether a security represents a creditor relationship should consider all other investments the reporting entity owns in the investee as well as any other contractual arrangements. A security that in substance possesses equity-like characteristics or represents an ownership interest in the issuer does not represent a creditor relationship. See Appendix I for examples of securities that, despite their legal form, do not represent a creditor relationship in substance.

2. An issuer credit obligation is a bond, the repayment of which is supported primarily by the general creditworthiness of an operating entity or entities. Support consists of direct or indirect recourse to an operating entity or entities, which includes holding companies with operating entity subsidiaries where the holding company has the ability to access the operating subsidiaries' cash flows through its ownership rights. An operating entity may be any sort of business entity, not-for-profit organization, governmental unit, or other provider of goods or services, but not a natural person or ABS Issuer (defined below). Examples of issuer credit obligations include, but are not limited to:

[1] This statement adopts the GAAP definition of a security as it is used in FASB Accounting Standards Codification Topics 320 and 860. Evaluation of an investment under this definition should consider the substance of the instrument rather than solely its legal form.

Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
c. It is either one of a class or series or by its terms is divisible into a class or series of shares, participations, interests or obligations.

a. U.S. Treasury securities;(INT 01-25)
b. U.S. government agency securities;
c. Municipal securities issued by the municipality or supported by cash flows generated by a municipally-owned asset or entity that provides goods or services (e.g., airport, toll roads etc.);
d. Corporate bonds issued by operating entities, including Yankee bonds and zero-coupon bonds;
e. Corporate bonds issued by holding companies that own operating entities;
f. Project finance bonds issued by operating entities;
g. ETCs, EETCs, and CTLs for which repayment is fully supported by a lease to an operating entity;
h. Bonds issued by REITS or similar property trusts;
i. Bonds issued by business development corporations, closed-end funds, or similar operating entities, in each case registered under the 1940 Act;
j. Convertible bonds issued by operating entities, including mandatory convertible bonds as defined in paragraph 11.b;
k. Fixed-income instruments specifically identified:
    i. Certifications of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition;
    ii. Bank loans that are obligations of operating entities, issued directly by a reporting entity or acquired through a participation, syndication or assignment;
    iii. Hybrid securities issued by operating entities, excluding surplus notes, subordinated debt issues which have no coupon deferral features, and traditional preferred stocks;
    iv. Debt instruments in a certified capital company (CAPCO).(INT 06-02)

[Need to incorporate concepts in paragraph 4 of SSAP No. 26R but not recast here for brevity.]

3. An asset[2] backed security is a bond issued by an entity (an "ABS Issuer") created for the primary purpose of raising debt capital backed by financial assets[3] or cash generating non-financial assets owned by the ABS Issuer, whereby repayment is primarily derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity[4]. In most instances, the ABS Issuer is not expected to continue functioning beyond the final maturity of the debt initially raised by the ABS Issuer. Also, many ABS Issuers are in the form of a trust or special purpose vehicle

[2] The underlying collateral supporting an asset backed security shall meet the definition of an asset by the ABS Issuer. Certain forms of collateral, such as rights to future cash flows, may not be recognized as assets by the selling entity but may be recognized as assets when sold to an ABS Issuer. These assets are permitted as the collateral supporting an asset backed security, although they may not represent an asset that can be liquidated to provide payment toward the issued debt obligations (i.e., if the future cash flows do not materialize). The limited ability to liquidate the underlying collateral supporting an asset backed security does not impact the structural determination of whether an issued security meets the definition of an asset backed security but may impact the recoverability of the investment, as well as the consideration of whether there is sufficient credit enhancement.

[3] SSAP No. 103R defines a financial asset as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right (a) to receive cash or another financial instrument from a second entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity. As a point of clarity, for the purposes of this standard, financial assets do not include assets for which the realization of the benefits conveyed by the above rights depends on the completion of a performance obligation (e.g., leases, mortgage servicing rights, royalty rights, etc.). These assets represent non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied.

[4] Dedicated cash flows from an operating entity can form the underlying defined collateral in an asset backed security. This dynamic, perhaps noted in a whole-business securitization, still reflects an asset backed security and not an issuer credit obligation.

("SPV"), though the presence or lack of a trust or SPV is not a definitive criterion for determining that a security meets the definition of an asset backed security.

There are two defining characteristics that must be present for a security to meet the definition of an asset backed security:

a. The assets owned by the ABS Issuer are either financial assets or cash-generating non-financial assets. Cash-generating non-financial assets are defined as assets that are expected to generate a meaningful[5] level of cash flows toward repayment of the bond through use, licensing, leasing, servicing or management fees, or other similar cash flow generation (for the avoidance of doubt, there must be a meaningful level of cash flows to service the debt, other than through the sale or refinancing of the assets). Reliance on cash flows from the sale or refinancing of cash generating non-financial assets does not preclude a bond from being classified as an asset backed security so long as the condition in the preceding sentence is met. See Appendix II for examples (2, 3 and 4) illustrating the evaluation of the meaningful criteria.

b. The holder of a debt instrument issued by an ABS Issuer is in a different economic position than if the holder owned the ABS Issuer's assets directly. The holder of the debt instrument is in a different economic position if such debt instrument benefits from sufficient[6] credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization. In instances where the assets owned by the ABS Issuer are equity interests, the debt instrument must have pre-determined principal and interest payments (whether fixed interest or variable interest) with contractual amounts that do not vary based on the appreciation or depreciation of the equity interests. See Appendix II for examples illustrating the evaluation of the sufficient criteria.

4. Whether an issuer of debt represents an operating entity or ABS Issuer is unambiguous in most instances, but certain instances may be less clear. For example, an entity may operate a single asset such as a toll road or power generation facility (e.g., project finance) which serves to collateralize a debt issuance, and the cash flows produced by the operation of the assets are pledged to service the debt. In many such instances, the entity is structured as a bankruptcy-remote entity that is separate from the municipality or project sponsor. Such entities have characteristics of operating entities as the operation of the asset constitutes a stand-alone business. They also have many common characteristics of ABS Issuers as they are formed for the purpose of raising debt capital backed by the cash flows from collateral held by a bankruptcy-remote entity. When viewed more holistically, these issuing entities are typically being used to facilitate the financing of an operating component of a project sponsor or municipality. The use of a bankruptcy-remote entity facilitates the efficient raising of debt to finance the operating project, but the primary purpose is to finance an operating project. Therefore, structures in which the issuing entity represents a stand-alone business producing its own operating revenues and expenses, where the primary purpose is to finance an operating project, shall be considered operating entities despite certain characteristics they may share with ABS Issuers.

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[5] The term "meaningful" is defined in the Glossary.
[6] The term "sufficient" is defined in the Glossary.

Note: The elements captured below are not components of the core bond definition. However, comments are requested on the proposal to separately identify on Schedule D-1 or a subschedule of D-1, those ABS that qualify as bonds under the definition and have certain characteristics noted below. The purpose of separate identification would be to improve transparency and provide more specific disclosures applicable to bonds with such characteristics.

A separate reporting section on Schedule D, Bonds is being contemplated, for the purpose of capturing additional disclosures for regulators, for the following:

Any asset backed securities where:

1) the underlying collateral comprises cash generating non-financial assets and does not meet the practical expedient for evaluating the meaningful criteria defined in paragraph 3a and the glossary, or

2) the underlying collateral comprises financial assets that are not self-liquidating.

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Glossary

Meaningful – What constitutes a "meaningful" level of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral is specific to each transaction, determined at origination, and should consider the following factors:

1. The price volatility in the principal market for the underlying collateral;
2. The liquidity in the principal market for the underlying collateral;
3. The diversification characteristics of the underlying collateral (i.e., types of collateral, geographic location(s), source(s) of cash flows within the structure, etc.);
4. The overcollateralization of the underlying collateral relative to the debt obligation; and
5. The variability of cash flows, from sources other than sale or refinancing, expected to be generated from the underlying collateral.

Factors #1 and #5 are directly related to the "meaningful" requirement. That is, as price volatility or variability of cash flows increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral must also increase. Factors #2, #3 and #4 are inversely related to the "meaningful" concept. That is, as liquidity, diversification or overcollateralization increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral may decrease.

As a practical expedient to determining whether a cash generating non-financial asset is expected to produce meaningful cash flows, a reporting entity may consider an asset for which less than 50% of the original principal relies on sale or refinancing to meet the meaningful criteria. In applying this practical expedient, only contractual cash flows of the non-financial asset may be considered. This practical expedient should not be construed to mean that assets cannot meet the meaningful criteria if they rely on sale or refinancing to service greater than 50% of the original principal or if they rely on cash flows that are not contracted at origination. Rather, such instances would require a complete analysis of the considerations described above.

Sufficient – The "sufficient" threshold is specific to each transaction; determined at origination; and refers to the level of credit enhancement a market participant (i.e., reasonable investor) would conclude is expected to absorb losses (or decreases in cash flows) to the same degree as other debt instruments of similar quality, under a range of stress scenarios (i.e., scenarios are similar to stress scenarios performed for other debt instruments of the same quality). Losses are those a market participant would estimate and considers historical losses (including loss recoveries) on similar collateral, current market conditions, reasonable and supportable forecasts, and prepayment assumptions associated with the collateral. Excluded from the estimate of expected losses are historical gains on similar collateral and expected market appreciation on the collateral.

The first loss tranche (or tranches if the first tranche is not itself sufficient) may be issued as part of the securitization in the form of a debt or equity interest, or it may be retained by the sponsor and not issued as part of the securitization. If the first loss tranche is issued as part of the securitization, and held by a reporting entity, the accounting should follow the guidance applicable to the type of instrument (i.e., debt vs. equity); however, regardless of the type of instrument, it does not qualify as a Schedule D bond and should be reported on Schedule BA.

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Appendix I

<u>Examples of securities that, despite their legal form, do not represent creditor relationships in substance:</u>

<u>Example I:</u>

A reporting entity invests in a private equity fund, whereby each investor is required to make 75% of its investment in the form of an unsecured debt investment and 25% in the form of an equity interest. Additionally, each investor owns a pro rata share of the unsecured debt investments and equity interests outstanding, and is restricted from selling, assigning or transferring the unsecured debt investment without also selling, assigning, or transferring the equity interest to the same party.

Rationale:

Although the unsecured debt investment appears to represent a creditor relationship in legal form, consideration of the substance of its terms in conjunction with the reporting entity's other interests in the fund, reflects that of an equity investment in substance. While the unsecured debt investment would have legal priority of payment over the equity interest, both interests are contractually required to be held in the same proportion by the reporting entity and cannot be independently sold, assigned, or transferred, which only gives the reporting entity priority of payment over itself. As such, the reporting entity is in the same economic position as if it held its entire investment in the form of an equity interest in the fund. Therefore, the unsecured debt investment does not represent a creditor relationship in substance. It would also be inappropriate to conclude that a component of a similar investment, but not exact replica of this transaction, represents a creditor relationship if it in substance does not put the holder collectively in a materially different economic position than holding an equity interest (e.g., the required equity interest was not exactly pro-rata). However, requirements to hold both debt and equity interests as a result of regulatory restrictions, such as regulatory risk retention rules, should not influence the conclusion that a debt investment represents a creditor relationship in substance.

<u>Example 2:</u>

A reporting entity invests in a debt instrument issued by a SPV that holds a large number of diversified equity interests with characteristics that support the production of predictable cash flows. The structure contains sufficient overcollateralization and liquidity provisions to ensure the production of adequate cash flows to service both principal and interest payments without significant reliance on refinancing or sale of the underlying equity investments. The debt instrument's periodic principal or interest payments, or both, contractually vary based on the appreciation or depreciation of the equity interests held in the SPV.

Rationale:

Because the instrument's principal or interest payments, or both, contractually vary with the appreciation or depreciation of the underlying equity interests, it contains an equity-like characteristic that is not representative of a creditor relationship. It would be inappropriate to conclude that a security with any

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variation in principal or interest payments, or both, due to underlying equity appreciation or depreciation, or an equity-based derivative, is a bond under this standard as such security would contain equity-like characteristics. A bond under this standard is required to have pre-determined principal and interest payments (whether fixed interest or variable interest) and comply with the structured note guidance within paragraph XXX.

Example 3:

A reporting entity invests in a debt instrument issued from a SPV that owns one or few equity interests, and the debt instrument does not meet the definition of an issuer credit obligation. The debt instrument benefits from sufficient credit enhancement as defined in paragraph 3b, but the timing, amount and likelihood of cash distributions from the underlying equity interests is highly uncertain. Additionally, the capital structure of the SPV does not contain adequate diversification or liquidity provisions to ensure the production of adequate cash flows to service the contractual principal and interest payments, and repayment relies primarily on the ability to refinance or sell the underlying equity interests at maturity.

Rationale:

The debt instrument does not qualify as a bond because the timing, amount, and likelihood of cash distributions from the underlying equity interests is highly uncertain, and because the capital structure of the SPV does not contain adequate diversification or liquidity provisions to ensure the production of adequate cash flows to service both principal and interest payments. Furthermore, the anticipated repayment significantly relies on the ability to refinance or sell the underlying equity interests at maturity.

Determining of whether a debt instrument represents a creditor relationship in substance when the source of cash flows for repayment is derived from underlying equity interests inherently requires significant judgment and analysis. Unlike a debt instrument collateralized by assets with contractual cash flows, debt instruments collateralized by equity interests are dependent on cash flow distributions that are not contractually required to be made and are not controlled by the issuer of the debt. As a result, there is a rebuttable presumption that a debt instrument collateralized by equity interests does not represent a creditor relationship in substance. Notwithstanding this rebuttable presumption, it is possible for such a debt instrument to represent a creditor relationship if the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer. Factors to consider in making this determination include but are not limited to:

- Number and diversification of the underlying equity interests
- Characteristics of the underlying equity interests (vintage, asset-types, etc.)
- Liquidity facilities
- Overcollateralization
- Waiting period for distributions/paydowns to begin
- Capitalization of interest
- Covenants (e.g., loan-to-value trigger provisions)
- Reliance on ongoing sponsor commitments

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Additionally, a debt instrument for which repayment relies significantly upon the ability to refinance or sell the underlying equity interests at maturity subjects the holder to a point-in-time equity valuation risk that is characteristic of the substance of an equity holder relationship rather than a creditor relationship. Therefore, such reliance would preclude the rebuttable presumption from being overcome.

The analysis of whether a debt instrument that relies on cash flows from underlying equity interests for repayment represents a creditor relationship in substance should be conducted and documented by a reporting entity at the time such an investment is acquired. The level of documentation and analysis required to demonstrate that the rebuttable presumption has been overcome may vary based on the characteristics of the individual debt instrument, as well as the level of third-party and/or non-insurer market validation to which the issuance has been subjected. For example, a debt instrument backed by fewer, less diversified funds would require more extensive and persuasive documented analysis than one backed with a larger number of diversified funds. Likewise, a debt instrument that has been successfully marketed to unrelated and/or non-insurer investors, may provide enhanced market validation of the structure compared to one held only by related party and/or insurer investors where capital relief may be the primary motivation for the securitization.

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Appendix II

<u>Examples of analysis of asset backed securities under the meaningful and/or sufficiency criteria as defined in paragraphs 3a and 3b:</u>

Example 1:

A reporting entity invests in debt instruments issued from a SPV sponsored by the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, "Agency or Agencies"). These debt instruments pass through principal and interest payments received from underlying mortgage loans held by the SPV to the debtholders proportionally, with principal and interest guaranteed by the Agencies. While there is prepayment and extension risk associated with the repayment of the underlying mortgage loans, the credit risk associated with the mortgage loans is assumed by the Agencies. The reporting entity expects the Agency guarantee to be sufficient to absorb losses to the same degree as other debt instruments of similar quality under a range of stress scenarios.

Rationale:

Although the reporting entity participates on a proportional basis in the cash flows from the underlying mortgage loans held by the SPV, the reporting entity is in a different economic position than if it owned the underlying mortgage loans directly because the credit risk has been redistributed and assumed by the Agencies. Because the Agency guarantee is expected to absorb losses to the same degree as other debt instruments of similar quality under a range of stress scenarios, it represents sufficient credit enhancement in accordance with the requirements in paragraph 3b.

Example 2:

A reporting entity invested in a debt instrument issued by a SPV that owns equipment which is leased to an equipment operator. The equipment operator makes lease payments to the SPV, which are passed through to service the SPV's debt obligation. While the debt is outstanding, the equipment and lease are held in trust and pledged as collateral for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the equipment as well as submit an unsecured lease claim in the lessee's bankruptcy for any defaulted lease payments. The loan-to-value at origination is 70%.

The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at debt maturity, there is a balloon payment due, totaling 50% of the original outstanding debt principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to decline to 40% considering the scheduled principal amortization payments net of the expected economic depreciation in the equipment value over the term of the debt. The equipment is expected to be subject to some market value volatility and periods of lower liquidity at certain points in time but has

a predictable value range and ready market over a longer period of time, such that the equipment could be liquidated over a reasonable period of time, if necessary.

Rationale:

The equipment is a cash generating non-financial asset which is expected to generate a meaningful level of cash flows for the repayment of the bonds via the existing lease that covers all interest payments and 50% of the principal payments. In reaching this determination, the reporting entity considered the predictable nature of the cash flows, which are contractually fixed for the life of the debt instrument, as well as the ability of the collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the equipment may have some market value volatility and periods of lower liquidity at points in time, the cash flows produced by the lease were concluded to reduce the loan balance to a level (40% loan-to-value) that would be able to be recovered by sale or refinancing even if it were to mature at such point in time..

The reporting entity also determined that the structure provides sufficient credit enhancement to conclude that investors are in a different economic position than holding the equipment directly. In reaching this conclusion, the reporting entity noted that the debt instrument starts with a 70% loan-to-value, which continues to improve over the life of the debt as the loan balance amortizes more quickly than the expected economic depreciation on the underlying equipment. In the context of the predictable nature of the cash flows and collateral value range over time, the reporting entity concluded this level of overcollateralization is expected to absorb losses to the same degree as other debt instruments of similar quality, including during periods of stressed valuations.

For the purposes of determining whether there is sufficient overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to consider any expected economic appreciation. Note that a debt instrument with a loan-to-value that is expected to decrease over time is not necessarily deemed to have sufficient overcollateralization. Rather, a wholistic sufficiency assessment must be made, evaluating the expected loan-to-value over the life of the transaction, in conjunction with the liquidity and market value volatility characteristics of the underlying collateral, particularly at points in time where the underlying equipment is expected to be off-lease or at the time of maturity, if refinancing or sale is required.

Example 3:

A reporting entity invested in a debt instrument with the same characteristics as described in Example 2, except that the existing equipment lease at the time of origination has a contractual term that is shorter than that of the debt instrument. It is expected with a high degree of probability that the lease will be renewed, and a substantial leasing market exists to replace the lessee should they not renew. However, in the unlikely circumstance that the equipment cannot be re-leased, there would not be enough cash flows to service the scheduled principal and interest payments, and the equipment would have to be liquidated to pay off the debt upon default.

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Rationale:

All details of Example 3, including the expected collateral cash flows, are consistent with those in Example 2, except that the cash flows in Example 2 are contractually fixed for the duration of the debt while the cash flows in Example 3 are subject to re-leasing risk. Notwithstanding the involvement of re-leasing risk, the reporting entity concluded that the ability to re-lease the equipment was highly predictable and supported the conclusion that the equipment was expected to produce meaningful cash flows to service the debt.

This distinction is to highlight that the expected cash flows of a cash-generating non-financial asset may or may not be contractually fixed for the term of the bond. Certain securitized cash flow streams may not by their nature lend themselves to long-term contracts (e.g., single-family home rentals), but may nevertheless lend themselves to the production of predictable cash flows. While the non-contractual nature of the cash flows is an important consideration in determining whether a non-financial asset is expected to produce meaningful cash flows to service the debt, it does not, in and of itself, preclude a reporting entity from concluding that the assets are expected to produce meaningful cash flows.

Example 4:

A reporting entity invested in a debt instrument issued by a SPV that owns equipment which is leased to an equipment operator. The equipment operator makes lease payments to the SPV, which are passed through to service the SPV's debt obligation. While the debt is outstanding, the equipment and lease are held in trust and pledged as collateral for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the equipment as well as submit an unsecured lease claim in the lessee's bankruptcy for any defaulted lease payments. The loan-to-value at origination is 70%.

The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at maturity, there is a balloon payment due, totaling 80% of the original outstanding principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to increase to 95% considering the scheduled principal amortization payments net of the expected economic depreciation in the equipment value over the term of the debt. The equipment is expected to be subject to some market value volatility and periods of lower liquidity at certain points in time, but has a predictable value range and ready market over a longer period of time, such that the equipment could be liquidated over a reasonable period of time, if necessary.

Rationale:

The equipment is a cash generating non-financial asset which is not expected to generate a meaningful level of cash flows for the repayment of the bonds via the existing lease that covers all interest payments and 20% of principal payments. In reaching this determination, the reporting entity considered that, while the cash flows being produced are predictable, the ability to recover the principal of the debt investment is almost entirely reliant on the equipment retaining sufficient value to sell or refinance to satisfy the debt.

The reporting entity also determined that the structure lacks sufficient credit enhancement to conclude that investors are in a different economic position than holding the equipment directly. In reaching this conclusion, the reporting entity noted that the debt starts with a 70% loan-to-value, but the overcollateralization is expected to deteriorate over the term of the debt as the equipment economically depreciates more quickly than the debt amortizes. This results in a high loan-to-value (i.e., 95%) at maturity, relative to the market value volatility of the underlying collateral. Despite the predictable nature of the cash flows, the reporting entity concluded that the debt instruments lacked a sufficient level of overcollateralization expected to absorb losses to the same degree as other debt instruments of similar quality, including during periods of stressed valuations. Therefore, the reporting entity concluded that it was in a substantially similar position as if it owned the equipment directly.

For the purposes of determining whether there is sufficient overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to factor in any expected economic appreciation. Note that a debt instrument with a loan-to-value that is expected to increase over time is not necessarily deemed to have insufficient overcollateralization. Rather, a wholistic sufficiency assessment must be made, evaluating the expected loan-to-value over the life of the transaction, in conjunction with the liquidity and market value volatility characteristics of the underlying collateral, particularly at points in time where the underlying equipment is expected to be off-lease or at the time of maturity, if refinancing or sale is required.

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NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

TO: Dale Bruggeman (OH), Chair, Statutory Accounting Principles (E) Working Group
Justin Schrader (NE), Chair, Risk-Focused Surveillance (E) Working Group

FROM: Philip Barlow (DC), Chair, Life Risk-Based Capital (E) Working Group

DATE: April 26, 2021

RE: Request for Consideration of Life Real Estate Proposal

The Life Risk-Based Capital (E) Working Group has received, discussed, and exposed for public comment until Monday, May 24th, a proposal from the American Council of Life Insurers (ACLI) to modify the treatment of real estate in the life risk-based capital (RBC) formula. One aspect included in the proposal is the incorporation of an adjustment to the factor applied based, in part, on the fair value of real estate reported in the annual statement, specifically Schedule A and Schedule BA. Concerns have been raised with respect to potential inconsistencies in the amount companies report due to questions relating to the actual use of these amounts, their verification and the potential latitude provided in the guidance which we understand to be, primarily, *Statement of Statutory Accounting Principles No. 40 – Real Estate Investments*. The Working Group would appreciate consideration by the Statutory Accounting Principles (E) Working Group on accounting and reporting aspects of the proposal and the Risk-Focused Surveillance (E) Working Group on verification and validation aspects of the proposal along with any comments deemed appropriate in order to assist the Working Group in its consideration of the proposal.

Attachment C is pending.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force
Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Credit Tenant Loan referral from the Statutory Accounting Principles (E) Working Group

DATE: May 1, 2021

In this memorandum and the subsequent responses to the questions from the Working Group in its communication of Jan. 22, 2021, the SVO would like to reflect its continued strong support for this asset class and the re-assessment of the current 5% cap on balloon payments in credit tenant loan (CTL) transactions. We thought it was important to highlight some of the unique characteristics of these investments and the potential risks posed by greater reliance on the residual value of the underlying property and increased reliance on rating agencies.

Credit Tenant Loan Overview

CTLs are a type of commercial real estate financing secured by one or more properties leased to a credit tenant. CTL structures are unique in that the credit risk is based solely upon the lessee's credit worthiness instead of the value of the real estate collateral. Pursuant to the lease terms of a CTL, the credit tenant is obligated to make rent payments regardless of casualty or condemnation and assumes responsibility for all operating, maintenance, and insurance expenses and real estate taxes with no lease "outs" (ways to avoid making lease or associated payments). Any obligations retained by the landlord, such as payment of maintenance, must be addressed though insurance or another acceptable mitigant. Additionally, CTLs are structured so that lease payments are available to timely pay the debt service, including the full amortization of the principal, along with all other costs related to the property. The investors benefit from a security interest in the real estate collateral but this protection only serves to benefit the noteholders if the lessee defaults on rent leading to a default on note payments.

Balloon Payments

The current Purposes and Procedures Manual of the Investment Analysis Office (the P&P) guidance permits balloon payments in CTL transactions of up to 5% of the original loan balance which do not correspond to a lease payment. This balloon amount can be greater so long as the risk is appropriately mitigated through residual value insurance or another mitigant. Since the final lease payment will not cover the balloon payment owed under the note, balloon payments are dependent on the proceeds from

the landlord's re-leasing of the property necessary for refinancing the debt or, failing that, its sale. Balloon payments therefore expose the noteholder to the residual value of the property and the risk that it might not be sufficient to cover the remaining balance of the note.

"Dark Value"

The value ascribed to real estate collateral is often called its "dark value." Dark value is estimated from the possible future re-leasing of the commercial property and includes lump-sum charges for lost rent, re-tenanting costs, brokerage costs, brokerage fees, unreimbursed maintenance, and other holding-period or re-leasing expenses. The existing 5% limit of on balloon payments in the CTL guidelines minimizes the exposure to the real estate collateral's dark value. However, with each percent increase in balloon payment size there is a lockstep increase in the residual exposure to the property's dark value and the ability to re-lease the asset at a sufficient rate.

<u>The SVO's Opinion</u>

The Working Group has asked the SVO whether it thinks it appropriate to revisit the 5% residual threshold in the CTL guidelines and, if so, to recommend an appropriate residual threshold. The SVO thinks the residual threshold should be revisited but we do not have a specific threshold to recommend. The SVO can assess the risk of, and assign NAIC Designations to, transactions with any level of residual exposure that the Working Group and Task Force approves, from 0% to 100%. The debt markets are awash in securities with repayment contingent on the re-leasing or liquidation of an asset and residual exposures at all levels, including greater than 100%. This shift in risk from the lessee's credit worthiness to the collateral asset's value can apply to any security backed by leased assets, whether they be railcars, aircraft, aircraft engines, vessels, shipping containers, etc., if repayment of the loan is dependent in part on the future re-leasing or sale of the asset. The appropriate residual threshold is really a question of what constitutes a bond for financial solvency, regulatory and statutory accounting purposes and, more specifically, what amount of residual exposure (i.e. direct exposure to an underlying asset at the end of an investment) should be permitted in insurance companies' debt investments. The SVO is not well positioned to answer with a specific threshold because its primary responsibility is credit assessment, which can performed on any level of residual risk, but would suggest the Working Group consider the financial effect to the investor of having to rely upon the future re-leasing of the property in order to refinance the debt or the sale of the asset for payment at maturity.

"Asset-Backed Securities" pursuant to Regulation AB

There have been recommendations for a 50% residual threshold based on the definition of "Asset-Backed Security" under the U.S. Securities and Exchange Commission's (SEC) Regulation AB (17 CFR § 220.1101). Regulation AB dictates the disclosure and reporting requirements for publicly offered asset backed securities which, as defined in the regulation, includes non-auto lease backed securities with residual exposures up to, but not including, 50%, by dollar amount, of the securitized pool balance. The residual threshold drops to 20% if the securities are offered as part of a shelf registration. The regulation was intended to provide for better disclosure of asset level information and, by providing investors with timely and sufficient information, to reduce the likelihood of undue reliance on credit ratings. A security

with greater than 50% residual exposure could also be registered with the SEC but with different disclosure and reporting requirements. Likewise, a security with 49% residual exposure which meets the Regulation AB definition of "Asset-Backed Security" could be privately placed. Neither security would be subject to Regulation AB, but we would assert both are "asset-backed" securities. We make this point to demonstrate that the Regulation AB definition of Asset-Backed Security, while convenient, is not necessarily a compelling basis for determining a level of residual exposure compatible with NAIC's regulatory objectives. According to the SEC's 2004 proposing release for Regulation AB (SEC Release Nos. 33-8419; 34-49644) the SEC arrived at the 50% threshold "after reviewing residual value percentages for typical lease-backed securitizations." The SEC's disclosure regulations and regulatory objectives should not necessarily influence the NAIC's regulatory financial solvency objective; one clear lesson from the Great Recession of 2007-2008 was that market convention and acceptance should not drive NAIC regulatory policy.

Rating Agencies

Markets will create any security an investor is willing to buy. Likewise, there is no limitation or restriction on what can be assigned a credit rating and one should never assume that because a security has a credit rating it is an appropriate investment for NAIC regulatory purposes. The SVO staff believes there is substantially less risk to investors when the residual asset exposure is limited. This is true for all securities that may have a residual asset exposure because there is far less transparency and consistency in assessing the risk of the residual asset, especially for small pools of non-commoditized assets like real estate. (We intentionally make the distinction between small pools of non-commoditized assets and large pools of commoditized assets, such as auto lease ABS, because it is possible to more accurately estimate cashflows for traditional asset backed securities, including the proceeds from the sale of the assets at the end of each lease, thereby more accurately mitigating residual asset risk.) The next few examples highlight the increase in variability and inconsistency in assessment of risk, even among rating agencies, for securities with large residual exposures.

The SVO staff has observed very different treatment by rating agencies of the valuation and refinancing or liquidation risk presented by exposure to the residual asset. Some rating agencies notch downward significantly from the rating of the lessee when there is substantial lease renewal and refinancing risk associated with the repayment of principal, while others notch up based on the property valuation. The assumptions and bases for property valuations, the biggest driver of risk when there is a large residual exposure, can vary significantly across the rating agencies. Some using capitalization rates, a key component of the valuation, in the 6.50-16.50% range depending upon the property type and location. Others do not provide stated capitalization rates in their methodology but apply rates in a lower narrower range of 6.00-7.50% in reports that we have seen leading to substantially higher valuations. These methodology difference have led to valuation difference of greater than 30-40% which significantly impact loan-to-values ratios.

One recent publicly rated (Nov. 2020) real estate lease backed transaction had a 76% residual exposure at maturity in 2035 for a facility leased by a U.S. government entity. The rating on the security was

notched downward five times to "A2" from the U.S. government's "AAA" rating and is now under ratings review for possible downgrade (Dec. 2020). Other rating agencies have taken the opposite approach and notched upward above the lessee's credit rating based on the collateral and the loan-to-value ratio, in some cases raising the transaction's credit rating two to five notches above the lessee's credit rating. For example, a non-conforming CTL transaction with a "BBB" rated large international company as tenant and a 37% residual exposure was rated "A+". In another transaction, the lessee was rated "BBB-" but the non-conforming CTL was rated "AA-" despite a 100% residual exposure. While these are only a few examples, they reflect the varied and highly inconsistent treatment of the risk of residual asset exposure and valuation across rating agency methodologies. It is the SVO staff's opinion that these methodology inconsistencies should be addressed if these securities are to be considered eligible for Filing Exemption. The ratings on other lease-backed securities may have similarly varied and inconsistent treatment but the SVO has not yet reviewed those security types in detail. We note that in the adopting release for revisions to Regulation AB in 2014 (Release Nos. 33-9638; 34-72982), the SEC, in referring to the financial crisis of 2007-2008, wrote, "The failures of credit ratings to accurately measure and account for the risks associated with certain asset-backed securities have been well documented," and, "The collapse of these 'investment-grade' rated securities was a major contributor to the financial crisis, and demonstrated the risks to investors of unduly relying on these securities' credit ratings without engaging in independent due diligence."

Specifically, responding to the Working Group's questions, the SVO staff's responses are below:

- *Whether it is appropriate to revisit the 5% residual asset risk threshold as a restriction for conforming CTLs.*

  The Task Force's adoption of the 5% residual asset risk threshold was generous under the CTL guidelines since it permits some exposure to the underlying real estate collateral in transactions assessed based on the credit worthiness of the lessee and allows them to be reported as a bond with comparable accounting and risk-based capital (RBC) treatment. Since the P&P guidance was adopted in the early 1990s, additional investment structures have been created to securitize lease payments for many types of assets well beyond the commercial real estate financing of CTLs and with residual asset exposure far in excess of 5%. In acknowledgment of the changes to the lease backed securities market since the CTL guidelines were adopted, the SVO recommends that the Working Group and Task Force re-consider the current 5% residual exposure threshold for CTLs and possibly for other lease-backed securities. As noted in several industry comments, CTLs have consistently performed well for insurers under the existing standards and the SVO believes that historical performance is directly related to the current structural framework, required mitigants and review process.

- *If applicable, a recommendation of an appropriate residual risk threshold.*

The SVO suggests limiting the residual asset risk exposure for CTLs and, possibly, for other lease-backed securities as well. As mentioned previously, as residual asset exposure increases, the security develops risk characteristics more like that of the underlying asset than that of an investment security making periodic payments of interest and principal. There are also separate reporting, statutory accounting, RBC, and investment limitations that would be applicable to the underlying assets were they to be held directly as an investment. Furthermore, the exposure is residual, meaning only determinable at or near maturity when the asset needs to be either re-leased or sold to satisfy note payment obligations. The P&P defines CTLs as being, " mortgage loans that are made primarily in reliance on the credit standing of a major tenant." Therefore, at a minimum, a “primarily” standard would be appropriate, meaning no residual exposure should be 50% or greater. The SVO staff believes that even 50% is a very high exposure to the underlying collateral asset's re-leasing or salability risk, meaning that at maturity the noteholder’s risk of repayment of the remaining outstanding half of its principal is directly tied to the value of the underlying real estate and the ability to re-lease the asset at a sufficient rate. (If held directly, a mortgage loan on real estate is reported on Schedule B.) A lower residual threshold would lessen that risk. Industry has often pointed to the strong performance of CTLs through times of economic distress. However, until now all CTLs filed with the SVO have been conforming CTLs with minimal residual exposure. We do not know how a CTL with a larger residual exposure would perform should the balloon payment come due and the property need to be re-leased or sold in a year when commercial real estate values are suppressed. Ultimately, the Working Group and the Task Force will need to decide, from a regulatory risk and reporting perspective, how much exposure to any small pools (including single asset pools) of non-commoditized assets is appropriate to still be reported on the bond schedule with an NAIC Designation and receive commensurate RBC treatment. The SVO will be able to assign an NAIC Designation to whatever residual threshold, 0% to 100%, the Working Group and Task Force ultimately decide upon.

- *Whether other mechanisms or compensating controls (beyond a residual risk insurance policy) could be incorporated as a mitigating factor for CTLs that exceed the 5% residual risk threshold (or a threshold as recommended)*.

  Yes. Residual risk insurance is the most common mitigant to residual risk, but the SVO would accept other mitigants including, but not limited to, non-cancellable guarantees, cash escrows and reserves, excess rent set asides and recourse to the lessee. We would propose that a list of mitigants not be limiting but rather examples, so that we can assess and make a determination on any proposes mitigant.

- *A listing of the nonconforming CTLs that were filed with the SVO in accordance with the direction of Interpretation (INT) 20-10. Please include high level details including outstanding principal and NAIC designation assigned by the SVO.*

The SVO has received 61 CTLs from when the INT 20-10 was issued through Apr. 21, 2021. There were 16 conforming CTLs ($0.406 billion), 27 non-conforming CTLs ($0.789 billion) and 18 transactions still pending documentation and review ($0.414 billion). The typical outstanding documentation included: primary legal agreement, CTL evaluation form, mortgage, residual value insurance, lease agreement, condemnation insurance, appraisal, and assignment of lease and rents. The list of security IDs and descriptions for non-conforming CTLs has been included in a regulator-only addendum. After reviewing the data for existing CTLs filed in 2020, we thought it was important to highlight that there is no universal issue description for these investments, making them difficult to identify. For the 1,018 CTLs filed with the SVO in 2020, 130 were identified as a CTL, 113 were identified as lease related, 326 were trust certificates, 160 were pass-thru certificates, 61 had no security type description, and the remaining 228 were various types of notes or certificates. Without reviewing the actual legal agreements and their terms, it will be very difficult to identify these securities without an insurer providing them to the SVO and the SVO identifying them in NAIC systems for all regulators.

In addition, the Working Group is also requesting information, to the extent possible, using best efforts, on (1) how many CTLs originally exceeded the residual risk threshold but were later deemed "conforming" due to mitigating factors, and (2) the nature of those factors (e.g. a residual risk insurance policy).

Primary Non-Conforming Issue	Count
Balloon >5% and <25%	2
Balloon >25% and <50%	6
Balloon >50% and <75%	3
Balloon >75% and <100%	0
Balloon >=100%	9
No casualty or condemnation gap insurance	6
Transaction involves keep-well agreement	1
	27

To put these numbers into perspective, the SVO staff reviews over 1,000 CTL transactions each year. During the three-year period from 2018 to 2020, the yearly filing average was 1,203 CTL filings comprising: 86 initial filings, 1,112 annual update filings, and 2 material change filings. The SVO has developed extensive experience reviewing CTL transactions.

We hope that the Task Force and Working Group find this report useful as they deliberate this important issue.