

TO: Thomas Botsko, Chair, Capital Adequacy (E) Task Force
Philip Barlow, Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group
Dale Bruggeman, Chair, Statutory Accounting Principles (E) Working Group

FROM: Carrie Mears, Chair, Valuation of Securities (E) Task Force

CC: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)
Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau
Julie Gann, Assistant Director, NAIC Solvency Policy
Dave Fleming, Sr. Life RBC Analyst, NAIC Financial Regulatory Affairs
Eva Yeung, Sr. P/C RBC Analyst/Technical Lead, NAIC Financial Regulatory Affairs

RE: Referral regarding a Proposed Amendment to Update the Definition of an NAIC Designation in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)

DATE: June 1, 2023

Summary – The Valuation of Securities (E) Task Force (VOSTF) requested that the Securities Valuation Office (SVO) staff make a comprehensive review of the definition of an NAIC Designation in the P&P Manual. The SVO identified that there are portions of the definition in both Parts One and Two some of which are redundant. In addition to the redundancy, this splitting of the definition has led to some users to the interpretation that there are two meanings of an NAIC Designation: one meaning, found in Part One, applicable to all securities, whether assigned NAIC Designations pursuant to the Filing Exemption process or by the SVO and a second meaning, found in Part Two, applicable only to securities assigned NAIC Designations by the SVO. It is the SVO staff's belief that there is only one definition of an NAIC Designation and that it is applicable however the NAIC Designation is assigned. The revisions proposed in the amendment, which is included with this referral, reflect a consolidation of the instructions that define an NAIC Designation to make a single uniform definition. It also includes updates to the definition to address questions and concerns raised about the purpose of NAIC Designations versus credit rating provider ratings. Additionally, the SVO is recommending consolidating the current "NAIC Designation Subscript S" section in Part Two into the revised NAIC Designation section in Part One because the application of a Subscript S to an NAIC Designation for other non-payment risks signifies a change in the meaning of the NAIC Designation and is a policy of the Task Force.

The majority of this proposed amendment involves moving text from Part Two, the "*Operational and Administrative Instructions Applicable to the SVO*", into Part One, the "*Policies of the NAIC Valuation of Securities (E) Task Force*". A clean version of the amendment was included to simplify the review, with the new text also clearly highlighted.

Referral Request – Given the importance of NAIC Designations in quantifying investment risk for various NAIC regulatory purposes and guidance, the Task Force is sending this referral with a request that your groups consider the revised definition and assess whether or not it meets your needs. If the definition meets your needs, please informally let the SVO staff know that no response will be submitted. If the definition does not meet your needs, please notify the SVO staff by June 29th that you will be proposing modification to the definition and we request that you submit those modification or a request for

additional time by July 31st so that the revisions or matter can be considered and discussed at the NAIC's Summer National Meeting. Thank you for your consideration of this request.

Please contact Charles Therriault or Marc Perlman with any questions.

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/Referrals/To CATF and SAPWG/VOSTF Referral to SAPWG CATF RBCIRE - NAIC Designation Def 2023-06-01.docx>

5/15/23



SVO



TO: Carrie Mears, 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 (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Proposed Amendment to Update the Definition of an NAIC Designation in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)

DATE: April 26, 2023

Summary – NAIC Designations are currently explained and defined in both Parts One and Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the “P&P Manual”). The SVO proposes both consolidating these explanations and definitions in Part One only and clarifying the meaning of an NAIC Designation including their use, purpose and risk addressed.

When the new format for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) was adopted on November 16, 2018 and published in the new format on April 7, 2019, several changes were made in an attempt to simplify the P&P Manual. It has since become apparent that some of those changes have led to the interpretation that there are two meanings of an NAIC Designation: one meaning, found in Part One, applicable to all securities, whether assigned NAIC Designations pursuant to the Filing Exemption process or by the Securities Valuation Office (“SVO”) and a second meaning, found in Part Two, applicable only to securities assigned NAIC Designations by the SVO. It is the SVO staff’s belief that there is only one definition of an NAIC Designation and that it is applicable however the NAIC Designation is assigned. To that end, the revisions proposed in this amendment have consolidated the instructions that define an NAIC Designation to make a single uniform definition and includes updates to the definition to address questions and concerns raised about the purpose of NAIC Designations versus credit rating provider ratings.

Additionally, the SVO recommends consolidating the current “NAIC Designation Subscript S” section in Part Two into the revised NAIC Designation section in Part One because the application of a Subscript S to an NAIC Designation for other non-payment risks signifies a change in the meaning of the NAIC Designation and is a policy of the Task Force.

Recommendation – The majority of the amendment involves moving text from Part Two, the Operational and Administrative Instructions Applicable to the SVO, into Part One, the Policies of the NAIC Valuation of Securities (E) Task Force. Additionally, the amendment would add clarifying language to the newly

combined explanation and definition of NAIC Designations. A clean version of the amendment has also been included to simplify the review, with the new text also clearly highlighted.

Proposed Amendment - The proposed text changes to the P&P Manual are shown below with additions in red font color and deletions in red strikethrough, as it would appear in the 2022 P&P Manual format. Editing notes have been added with [] to explain section moves. New text is highlighted in yellow.

(VERSION WITH CHANGES DISPLAYED AND ADDITIONS HIGHLIGHTED)

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

POLICIES PERTAINING TO SVO AND SSG OPERATIONS

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~~NAIC Designations~~

[Editing note: moved from Part One, paras. 37-39 to the new “NAIC Designations” section within Part One]

~~37. The SVO’s analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation that is notched to reflect the position of the specific liability in the issuer’s capital structure. Collectively, NAIC Designations as defined in this Manual describe a credit quality risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk except when accompanied by the NAIC Designation subscript, described below.~~

- ~~▪ Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member’s department of insurance can better identify regulatory treatment.~~
- ~~▪ Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.~~
- ~~▪ The ability of an insurance company to realize payment on a financial obligation can 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, such as volatility/interest rate, prepayment, extension or liquidity risk.~~
- ~~▪ An NAIC Designation must be interpreted by the NAIC member in context of the NAIC Financial Regulation Standards and Accreditation Program, other characteristics of the investment, and the specific financial and regulatory status of the insurance company.~~

~~38. The result of the SVO’s credit analysis, expressed as an opinion of credit quality by assignment of an NAIC Designation shall be further expanded into NAIC Designation Categories as, and for the purposes, discussed in this Manual.~~

~~**NOTE:** See “Production of NAIC Designations” in Part Two.~~

Other Non-Payment Risk in Securities

~~39. The result of the SVO's analysis of securities for other non-payment risk is expressed by the assignment of an NAIC Designation Subscript S and the application of the notching procedures described below.~~

~~NOTE: See "NAIC Designation Subscript S" and "SVO Notching Guidelines" in Part Two.~~

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NAIC DESIGNATIONS

NAIC DESIGNATIONS

Definitions Use and Purposes of NAIC Designations

88. **NAIC Designations** are proprietary symbols of the NAIC. The SVO, the SSG and, under certain circumstances, insurers, produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/TF in this Manual. NAIC Designations identify a category, ~~or band of credit risk,~~ or gradations of credit quality ~~and credit risk~~ identified by the **NAIC 1** through **NAIC 6** symbols, except when accompanied by the NAIC Designation Subscript S, denoting Other Non-Payment Risks, further discussed and defined in this Manual.

[Editing note: Moved from Part Two, para. 18]

89. **NAIC Designations** reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default.

90. **NAIC Designations** are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law *[Editing note: Moved from Part Two, para. 18]* and must be interpreted by the NAIC member in context of the NAIC Financial Regulation Standards and Accreditation Program, other characteristics of the investment, and the specific financial and regulatory status of the insurance company. *[Editing note: Moved from Part One, para. 37]* ~~NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual.~~ *[Editing note: Deleted from Part Two, para. 18]*

91. **NAIC Designations** must also be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) and other NAIC guidance. For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.

92. ~~NAIC Designation~~ — Means any one of the gradations of credit quality and credit risk identified by the ~~NAIC 1 through NAIC 6~~ symbols further discussed and defined in this Manual and may reflect notching pursuant to one or both of the notching procedures discussed in this Manual. ~~NAIC Designations are proprietary symbols of the NAIC to be used by the SVO and SSG or under certain circumstances by an insurer to denote a category or band of credit risk.~~

[Editing note: Originally in Part One, para. 88]

NAIC DESIGNATIONS — RISKS ADDRESSED BY NAIC DESIGNATIONS
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[Editing note: moved from Part One, para. 37]

93. The ~~NAIC's SVO's~~ analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation ~~and Designation Category~~ that ~~is~~ ~~may be~~ notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations ~~and Designation Categories~~, as defined in this Manual, describe a credit quality-risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk, ~~described below~~, except when accompanied by the NAIC Designation S~~ubscript~~ S, denoting Other Non-Payment Risks ~~described below~~.

- Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.
- Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.
- The ability of an insurance company to realize payment on a financial obligation can be affected by factors not related to credit risk or by the manner in which the repayment promise has been structured. ~~NAIC Designations may be adjusted to reflect Other Non-Payment Risks, as described in this manual.~~
- ~~An NAIC Designation shall reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default. It will also reflect consideration to potential "tail risks" (e.g. the probability that a security's payment default will be more than three standard deviations from the mean is greater than what is shown by a normal distribution).~~

- NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk, though these other risks may be reflected in Other Non-Payment Risks, as described in this manual.

NAIC DESIGNATION SUBSCRIPT S (OTHER NON-PAYMENT RISK)
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NAIC Designation Subscript S

94. An objective of the VOS/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is required to identify securities that contain such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer, so this can be reflected in the NAIC Designation assigned to the security through the application of the notching process.

[Editing note: Moved from Part One, para. 90]

~~**NOTE:** See “NAIC Designation Subscript S” in Part Two.~~

Description of Other Non-Payment Risk

95. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.

[Editing note: Moved from Part Two, para. 33]

96. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.

[Editing note: Moved from Part Two, para. 34]

97. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a schedules basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).

[Editing note: Moved from Part Two, para. 35]

98. Using the broad concepts identified above, non-payment risk may be present when:

- A reporting insurance company takes on a participatory risk in the transaction;

Illustration – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.

- The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;

Illustration – A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.

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

[Editing note: Moved from Part Two, para. 36]

- The governing agreements permit irregular or conditional payments that are incompatible with the notion of an issuer making periodic scheduled payments of interest and repaying principal in full to the insurer on a date certain;

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

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

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

Illustration – A security with an interest payment deferral feature that does not capitalize interest into principal or permits interest deferral for greater than twenty-four months or past legal maturity.

- ~~Agrees to an exposure that has the potential to result in a significant delay in payment of contractually promised interest and/or a return of principal in an amount less than the original investment.~~

[Editing note: Originally in Part Two, para. 37]

Directive to the SVO to Assign the Subscript S Symbol

99. The VOS/TF expressly assigns to the SVO the responsibility for assessing Other Non-Payment Risk and the authority to notch NAIC Designations and assign the Subscript S Symbol, accordingly. It does so in recognition that credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes. The VOS/TF may periodically request the SVO report to it on information the SVO gathers from its review of Subscript S securities, including, for example, volume of such securities and the types of other non-payment risks.

Meaning of the Subscript S Symbol

100. An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows: **NAIC 2S**.

[Editing note: Moved from Part Two, para. 38]

101. The SVO shall assess securities for other non-payment risk:
- Routinely, for any security or financial product filed with the SVO.
 - As part of the analysis of a security or financial product submitted to the SVO under the RTAS – Emerging Investment Vehicle process discussed in of this Manual.
 - When requested to do so by any state insurance regulator acting pursuant to this Manual, and:
 - When requested by the VOS/TF; or
 - In support of any other NAIC group engaged in the analysis of investment risks in new securities.

~~**NOTE:** See “NAIC Designation Subscript S” in Part One.~~

[Editing note: Moved from Part Two, para. 39]

Other Non-Payment Risk in Securities

~~96. The result of the SVO's analysis of securities for other non-payment risk is expressed by the assignment of an NAIC Designation Subscript S and the application of the notching procedures described below in this Manual.~~

[Editing note: Originally in Part One, para. 39]

~~**NOTE:** See "NAIC Designation Subscript S" and "SVO Notching Guidelines" in Part Two.~~

APPLICATION OF NAIC DESIGNATIONS

102. **NAIC 1** is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer's credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An **NAIC 1** obligation should be eligible for the most favorable treatment provided under the NAIC Financial Regulation Standards and Accreditation Program.

[Editing note: Moved from Part Two, para. 19]

103. **NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An **NAIC 2** obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

[Editing note: Moved from Part Two, para. 20]

104. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

[Editing note: Moved from Part Two, para. 21]

105. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer’s credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer’s capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

[Editing note: Moved from Part Two, para. 22]

106. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer’s credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

[Editing note: Moved from Part Two, para. 23]

107. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.

[Editing note: Moved from Part Two, para. 24]

NOTE: See ~~“NAIC Designations,”~~ “Prohibition on Use of NAIC Designation in a Covenant” and “Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force” in Part One; ~~“NAIC Designation Categories”~~ below; and “Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities” in Part Three.

APPLICATION OF NAIC DESIGNATION CATEGORIES

108. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories, ~~as described and defined in this Manual.~~

[Editing note: Moved from Part Two, para. 25]

109. **NAIC Designation Category** – Means and refers to 20 more granular delineations of credit risk in the **NAIC 1** through **NAIC 6** credit risk scale used by the VOS/TF to relate credit risk in insurer-owned securities to a risk-based capital factor assigned by the NAIC Capital Adequacy (E) Task Force. Each delineation of credit risk is represented by a letter (a Modifier) which modifies the NAIC Designation grade to indicate a more granular measure of credit risk within the NAIC Designation grade. The more granular delineations of credit risk are distributed as follows: 7 for the **NAIC 1** Designation grade indicated by the letters A through G; 3 delineations each for each of the NAIC Designation grades **NAIC 2**, **NAIC 3**, **NAIC 4** and **NAIC 5** indicated by the letters A, B and C and 1 delineation for NAIC Designation grade **NAIC 6**. The NAIC Designation Category framework is shown in this Manual. All Modifiers roll up into the respective NAIC Designation grade as they are a subset of them.

~~**NOTE:** See “Production of NAIC Designations” in Part Two.~~
[Editing Note: Moved from Part One, para. 89.]

110. **NAIC Designation Categories** are a subset of **NAIC Designations** and are used by the VOS/TF to link the NAIC risk-based-capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF’s credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
1		A		1.A
1		B		1.B
1		C		1.C
1		D		1.D
1		E		1.E
1		F		1.F
1		G		1.G
2		A		2.A
2		B		2.B
2		C		2.C
3		A		3.A
3		B		3.B
3		C		3.C
4		A		4.A
4		B		4.B
4		C		4.C
5		A		5.A
5		B		5.B

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
5		C		5.C
6				6

[Editing note: Moved from Part Two, para. 26]

111. NAIC Designations and Designation Categories may be adjusted in accordance with the notching procedures described in this Manual below so that an NAIC Designation and Designation Category for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations and Designation Categories may also be adjusted by notching to reflect the existence of Other Non-Payment Risks in the specific security in accordance with the procedures described in this Manual associated with NAIC Designations Subscript S.

[Editing note: Moved from Part Two, para. 18]

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION

112. An insurance company that self-assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.

[Editing note: Moved from Part Two, para. 27]

113. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met.

[Editing note: Moved from Part Two, para. 28]

114. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation.

[Editing note: Moved from Part Two, para. 29]

115. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.

[Editing note: Moved from Part Two, para. 30]

116. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.
[Editing note: Moved from Part Two, para. 31]

117. Securities that are residual tranches or interests, as defined in *SSAP 43R – Loan Backed and Structured Securities*, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.
[Editing note: Moved from Part Two, para. 32]

~~**NOTE REGARDING RESIDUAL TRANCHES OR INTERESTS:** For 2021 year-end reporting only, residual tranches or interests previously reported on Schedule D-1: Long-Term Bonds shall be permitted to be reported on Schedule D-1 with an NAIC 6* Designation, however an NAIC 5GI is not permitted.~~

NOTE: The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.
[Editing note: Moved from Part Two, para. 32]

NAIC General Interrogatory

118. **NAIC 5GI** and NAIC Designation Category **NAIC 5.B GI** is assigned by an insurance company to certain obligations that meet all of the following criteria:
- Documentation necessary to permit a full credit analysis of a security by the SVO does not exist or an NAIC CRP credit rating for an FE or PL security is not available.
 - The issuer or obligor is current on all contracted interest and principal payments.
 - The insurer has an actual expectation of ultimate payment of all contracted interest and principal.
- [Editing note: Moved from Part One, para. 91]*

NAIC PLGI

119. Effective July 1, 2018, insurance companies shall be responsible for providing the SVO copies of private rating letters for PL securities, where applicable, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs. For PL Securities issued prior to January 1, 2018, if an insurance company cannot provide a copy of the rating letter to the SVO due to confidentiality concerns and the rating is not included in a CRP credit rating feed (or other form of direct delivery from the NAIC CRP), the insurer shall report such securities on such securities' General Interrogatory to be developed for this purpose (i.e., a PLGI security).

[Editing note: Moved from Part One, para. 92]

Monitoring of SVO-Designated Securities

120. The SVO shall monitor, on an ongoing basis through the information provided by insurers as required by the Material Credit Events Filing described in this Manual, improvements and deterioration of credit quality of securities that are not filing exempt.

[Editing note: Moved from Part One, para. 93]

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS
APPLICABLE TO THE SVO

~~PRODUCTION OF NAIC DESIGNATIONS [EDITING NOTE: MOVED TO PART ONE “NAIC DESIGNATIONS”.]~~

~~NAIC DESIGNATIONS~~

- ~~18. NAIC Designations are proprietary symbols of the NAIC. The SVO and sometimes the SSG produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/IF in this Manual. NAIC Designations identify a category or band of credit risk. NAIC Designations are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law. NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer’s capital structure. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual.~~
- ~~19. NAIC 1 is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer’s credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An NAIC 1 obligation should be eligible for the most favorable treatment provided under the NAIC Financial Regulation Standards and Accreditation Program.~~
- ~~20. NAIC 2 is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer’s credit profile is reasonably stable. This means that for the present, the obligation’s protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An NAIC 2 obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~
- ~~21. NAIC 3 is assigned to obligations of medium quality. Credit risk is intermediate and the issuer’s credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer’s capacity to make timely payments. An NAIC 3 obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

- ~~22. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~
- ~~23. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~
- ~~24. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

~~**NOTE:** See "NAIC Designations," "Prohibition on Use of NAIC Designation in a Covenant" and "Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force" in Part One; "NAIC Designation Categories" below; and "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three.~~

NAIC DESIGNATION CATEGORIES

- ~~25. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories, as described and defined in this Manual.~~
- ~~26. NAIC Designation Categories are a subset of NAIC Designations and are used by the VOS/TF to link the NAIC risk-based capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.~~

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
1		A		1.A
1		B		1.B
1		C		1.C
1		D		1.D
1		E		1.E
1		F		1.F
1		G		1.G
2		A		2.A
2		B		2.B
2		C		2.C
3		A		3.A
3		B		3.B
3		C		3.C
4		A		4.A
4		B		4.B
4		C		4.C
5		A		5.A
5		B		5.B
5		C		5.C
6				6

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION

- ~~27. An insurance company that self assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.~~
- ~~28. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met.~~
- ~~29. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation.~~
- ~~30. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.~~
- ~~31. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.~~
- ~~32. Securities that are residual tranches or interests, as defined in SS/AP 43R—Loan Backed and Structured Securities, shall be reported on Schedule BA—Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation. ———~~

~~**NOTE REGARDING RESIDUAL TRANCHES OR INTERESTS:** For 2021 year-end reporting only, residual tranches or interests previously reported on Schedule D-1: Long-Term Bonds shall be permitted to be reported on Schedule D-1 with an NAIC 6* Designation, however an NAIC 5GI is not permitted.~~

~~**NOTE:** The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.~~

NAIC DESIGNATION SUBSCRIPT S

Description of Other Non-Payment Risk

- ~~33. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.~~
- ~~34. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.~~
- ~~35. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a scheduled basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).~~
- ~~36. Using the broad concepts identified above, non-payment risk may be present when:~~
- ~~▪ A reporting insurance company takes on a participatory risk in the transaction;~~

Illustration — The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.
 - ~~▪ The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;~~

Illustration — A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.

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

~~37. Agrees to an exposure that has the potential to result in a significant delay in payment of contractually promised interest and/or a return of principal in an amount less than the original investment.~~

Meaning of the Subscript S Symbol

~~38. An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows: **NAIC 2S**.~~

~~39. The SVO shall assess securities for other non-payment risk:~~

- ~~▪ Routinely, for any security or financial product filed with the SVO.~~
- ~~▪ As part of the analysis of a security or financial product submitted to the SVO under the RTAS—Emerging Investment Vehicle process discussed in of this Manual.~~
- ~~▪ When requested to do so by any state insurance regulator acting pursuant to this Manual, and:~~

~~*When requested by the VOS/TF; or*~~

~~*In support of any other NAIC group engaged in the analysis of investment risks in new securities.*~~

NOTE: See “NAIC Designation Subscript S” in Part One.

**(CLEAN VERSION WITHOUT CHANGES DISPLAYED WITH ADDITIONS
HIGHLIGHTED)**

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

NAIC DESIGNATIONS**NAIC DESIGNATIONS****Use and Purposes of NAIC Designations**

88. **NAIC Designations** are proprietary symbols of the NAIC. The SVO, the SSG and, under certain circumstances, insurers, produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/TF in this Manual. NAIC Designations identify a category, or gradations of credit quality identified by the NAIC 1 through NAIC 6 symbols, except when accompanied by the NAIC Designation Subscript S, denoting Other Non-Payment Risks, further discussed and defined in this Manual.
89. **NAIC Designations** reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default.
90. **NAIC Designations** are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law and must be interpreted by the NAIC member in context of the NAIC Financial Regulation Standards and Accreditation Program, other characteristics of the investment, and the specific financial and regulatory status of the insurance company.
91. **NAIC Designations** must also be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) and other NAIC guidance. For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.

RISKS ADDRESSED BY NAIC DESIGNATIONS

92. The NAIC's SVO's analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation and Designation Category that is may be notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations and Designation Categories, as defined in this Manual, describe a credit quality-risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk, described below, except when accompanied by the NAIC Designation Subscript S, denoting Other Non-Payment Risks.

- Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.
- Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.
- The ability of an insurance company to realize payment on a financial obligation can be affected by factors not related to credit risk or by the manner in which the repayment promise has been structured. **NAIC Designations may be adjusted to reflect Other Non-Payment Risks, as described in this manual.**
- **An NAIC Designation shall reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default. It will also reflect consideration to potential "tail risks" (e.g. the probability that a security's payment default will be more than three standard deviations from the mean is greater than what is shown by a normal distribution).**
- NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk, **though these other risks may be reflected in Other Non-Payment Risks, as described in this manual.**

NAIC DESIGNATION SUBSCRIPT S (OTHER NON-PAYMENT RISK)
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NAIC Designation Subscript S

93. An objective of the VOS/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is required to identify securities that contain such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer, so this can be reflected in the NAIC Designation assigned to the security through the application of the notching process.

Description of Other Non-Payment Risk

94. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.
95. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.
96. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a schedules basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).
97. Using the broad concepts identified above, non-payment risk may be present when:
- A reporting insurance company takes on a participatory risk in the transaction;
Illustration – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.
 - The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;
Illustration – A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.
Illustration – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity dates (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.

- The governing agreements permit irregular or conditional payments that are incompatible with the notion of an issuer making periodic scheduled payments of interest and repaying principal in full to the insurer on a date certain;

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

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

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

Illustration – A security with an interest payment deferral feature that does not capitalize interest into principal or permits interest deferral for greater than twenty-four months or past legal maturity.

Directive to the SVO to Assign the Subscript S Symbol

98. The VOS/TF expressly assigns to the SVO the responsibility for assessing Other Non-Payment Risk and the authority to notch NAIC Designations and assign the Subscript S Symbol, accordingly. It does so in recognition that credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes. The VOS/TF may periodically request the SVO report to it on information the SVO gathers from its review of Subscript S securities, including, for example, volume of such securities and the types of other non-payment risks.

Meaning of the Subscript S Symbol

99. An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows: **NAIC 2S**.
100. The SVO shall assess securities for other non-payment risk:
 - Routinely, for any security or financial product filed with the SVO.
 - As part of the analysis of a security or financial product submitted to the SVO under the RTAS – Emerging Investment Vehicle process discussed in of this Manual.
 - When requested to do so by any state insurance regulator acting pursuant to this Manual, and:
 - When requested by the VOS/TF; or

- In support of any other NAIC group engaged in the analysis of investment risks in new securities.

APPLICATION OF NAIC DESIGNATIONS

101. **NAIC 1** is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer's credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An **NAIC 1** obligation should be eligible for the most favorable treatment provided under the NAIC Financial Regulation Standards and Accreditation Program.
102. **NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An **NAIC 2** obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
103. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
104. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

105. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.
106. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.

NOTE: See “Prohibition on Use of NAIC Designation in a Covenant” and “Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force” in Part One; and “Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities” in Part Three.

APPLICATION OF NAIC DESIGNATION CATEGORIES

107. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories.
108. **NAIC Designation Category** – Means and refers to 20 more granular delineations of credit risk in the **NAIC 1** through **NAIC 6** credit risk scale used by the VOS/TF to relate credit risk in insurer-owned securities to a risk-based capital factor assigned by the NAIC Capital Adequacy (E) Task Force. Each delineation of credit risk is represented by a letter (a Modifier) which modifies the NAIC Designation grade to indicate a more granular measure of credit risk within the NAIC Designation grade. The more granular delineations of credit risk are distributed as follows: 7 for the **NAIC 1** Designation grade indicated by the letters A through G; 3 delineations each for each of the NAIC Designation grades **NAIC 2**, **NAIC 3**, **NAIC 4** and **NAIC 5** indicated by the letters A, B and C and 1 delineation for NAIC Designation grade **NAIC 6**. The NAIC Designation Category framework is shown in this Manual. All Modifiers roll up into the respective NAIC Designation grade as they are a subset of them.
109. **NAIC Designation Categories** are a subset of **NAIC Designations** and are used by the VOS/TF to link the NAIC risk-based-capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
1		A		1.A
1		B		1.B
1		C		1.C
1		D		1.D
1		E		1.E
1		F		1.F
1		G		1.G
2		A		2.A
2		B		2.B
2		C		2.C
3		A		3.A
3		B		3.B
3		C		3.C
4		A		4.A
4		B		4.B
4		C		4.C
5		A		5.A
5		B		5.B
5		C		5.C
6				6

110. NAIC Designations and Designation Categories may be adjusted in accordance with the notching procedures described in this Manual below so that an NAIC Designation and Designation Category for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations and Designation Categories may also be adjusted by notching to reflect the existence of Other Non-Payment Risks in the specific security in accordance with the procedures described in this Manual associated with NAIC Designations Subscript S.

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION

111. An insurance company that self-assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.

112. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met.
113. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation.
114. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.
115. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.
116. Securities that are residual tranches or interests, as defined in *SSAP 43R – Loan Backed and Structured Securities*, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.

NOTE: The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.

NAIC General Interrogatory

117. **NAIC 5GI** and NAIC Designation Category **NAIC 5.B GI** is assigned by an insurance company to certain obligations that meet all of the following criteria:
- Documentation necessary to permit a full credit analysis of a security by the SVO does not exist or an NAIC CRP credit rating for an FE or PL security is not available.
 - The issuer or obligor is current on all contracted interest and principal payments.
 - The insurer has an actual expectation of ultimate payment of all contracted interest and principal.

NAIC PLGI

118. Effective July 1, 2018, insurance companies shall be responsible for providing the SVO copies of private rating letters for PL securities, where applicable, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs. For PL Securities issued prior to January 1, 2018, if an insurance company cannot provide a copy of the rating letter to the SVO due to confidentiality concerns and the rating is not included in a CRP credit rating feed (or other form of direct delivery from the NAIC CRP), the insurer shall report such securities on such securities' General Interrogatory to be developed for this purpose (i.e., a PLGI security).

Monitoring of SVO-Designated Securities

119. The SVO shall monitor, on an ongoing basis through the information provided by insurers as required by the Material Credit Events Filing described in this Manual, improvements and deterioration of credit quality of securities that are not filing exempt.

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-05-15 Interim meeting/01-Definition of NAIC Designation Part Two/2023-012.05 P&P Updated Def of NAIC Desig v7.docx>