



MEMORANDUM

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

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

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

RE: **Updated** - Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Private Rating Letter Rationale Report Only

DATE: **December 7, 2020** ~~October 30, 2020~~

1. Summary –The IAO staff discussed with the Task Force at its May 14th meeting the IAO’s concerns with bespoke securities and the NAIC’s excessive reliance on credit rating provider (CRP) ratings to assess investment risk and for regulatory purposes. At that meeting the Task Force exposed the IAO’s memorandum, dated February 27, 2020, summarizing these concerns. The Task Force requested the SVO make incremental recommendations to address these issues.

On October 23rd of this year the Financial Condition (E) Committee directed the Task Force to include a new charge for 2021; specifically, to, “implement policies to oversee the NAIC’s staff administration of rating agency ratings used in NAIC processes, including, staff’s discretion over the applicability of their use in its administration of Filing Exemption.” In furtherance of the proposed new Task Force charge and the Task Force’s request for incremental recommendations, the SVO proposes taking a first step towards implementation of some of its recommendations in its memo by increasing SVO scrutiny of PL securities, many of which are bespoke securities.

At the Task Force meeting on November 14th, the Task Force directed the SVO to update its proposed amendment to have the Private Rating Letter Rationale Reports filed with the SVO but without the SVO’s discretion over evaluating the appropriateness of the rating or methodology utilized, at least at this time. The SVO still recommends that it be granted this oversight authority and will be scheduling a regulator-only call in 2021 to review with the Task Force PLR transactions which appear to be either ineligible for filing exemption, ineligible for Schedule D reporting and/or where there is a material difference in opinion as to the risk

2. Recommendation for oversight of PL Securities – In its bespoke securities memo the SVO described its concern that its lack of authority to use its judgment in determining whether a CRP rating is useful for NAIC purposes (meaning its rating methodology may not be appropriate for, or consistent with, the assessment of investment risk for statutory purposes) has fed an increase in the use of bespoke securities, many of which are assigned NAIC designations through the Filing Exempt (FE) process, which includes the private letter rating process. To begin to address this lack of meaningful oversight of CRP ratings, the SVO proposes, as it did in its memo, that securities assigned private letter ratings be submitted to it for review. Understanding the many CRP private rating letters include little or no analysis

EXECUTIVE OFFICE • 444 North Capitol Street NW, Suite 700 • Washington, DC 20001-1509

p | 202 471 3990 f | 816 460 7493

CENTRAL OFFICE • 1100 Walnut Street, Suite 1500 • Kansas City, MO 64106-2197

p | 816 842 3600 f | 816 783 8175

CAPITAL MARKETS & INVESTMENT ANALYSIS OFFICE • One New York Plaza, Suite 4210 • New York, NY 10004

p | 212 398 9000 f | 212 382 4207

www.naic.org

beyond the assigned private rating, the SVO recommends that for a PL security to receive an NAIC Designation the SVO must receive, along with the private rating letter, a related private rating letter rationale report providing more in-depth analysis of the transaction, the methodology used to arrive at the private rating, and, as appropriate, discussion of the transaction's credit, legal and operational risks and mitigants. With both the private rating letter and the private rating letter rationale report the SVO would be able to determine (i) whether the private credit rating is an Eligible NAIC CRP Rating, meaning the security type is eligible to be reported on Schedule D and that it is appropriate for and NRSRO credit rating to be used to determine the regulatory treatment of the security, and (ii) whether the SVO agrees with the private credit rating. The SVO would have full discretion, based on its reasonable review of the private rating letter and the supporting rationale report, to assign an NAIC designation equivalent to the CRP PLR, to require the security to be filed for review or, to decline to assign any NAIC designation.

The SVO understands there are potential obstacles to attaining private rating letter rationale reports such as CRP confidentiality policies. However, the SVO thinks such analysis is crucial to its ability to best determine whether a rating is a satisfactory assessment of investment risk for statutory purposes due to the typical private rating letter's lack of analysis and transparency. As such the SVO is committed to working with industry and CRPs to find solutions to possible obstacles.

3. Proposed Amendment – The SVO proposes the following amendments to Parts One and Three of the Purposes and Procedures Manual of the Investment Analysis Office to permit the SVO to review all PL securities whether processed through a feed or submitted directly to the SVO and would require insurance company filers to provide private rating letter rationale reports for each security. The following text in red shows the proposed Purposes and Procedures Manual revisions. Updates are highlighted in yellow.

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

FILING EXEMPTIONS

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<p style="text-align: center;">POLICIES APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL) RATING SECURITIES</p>
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Policy Considerations

83. In connection with the implementation of the verification procedure for PL securities, the VOS/TF acknowledges that the practices adopted by NAIC CRPs in relation to the distribution of private rating letters for what the NAIC refers to as PL securities, including their confidentiality procedures and agreements, are integral to the business models of private for-profit entities that the NAIC does not regulate and which the NAIC stands in the relation of a customer of rating services. Accordingly, the SVO, as NAIC staff, shall not be responsible for negotiating with NAIC CRPs to modify their confidentiality practices or provide data-feeds to the SVO. However, if an NAIC CRP shall determine that it is willing to modify its confidentiality provisions or provide such data-feed or an alternative process so that the SVO can obtain electronically, copies of private rating letters and private rating letter rationale reports for PL securities issued by that NAIC CRP instead of by requiring insurers to provide PDF files, then the SVO is authorized to work with the NAIC CRP to obtain and integrate the private rating letters and private rating letter rationale reports or the data-feeds into NAIC systems to create electronic processes that will permit electronic verification that the insurer-owned PL security have been assigned an NAIC CRP Eligible Credit Rating. Individual insurers and/or representatives of the insurance industry are encouraged to find ways to resolve confidentiality restrictions imposed by NAIC CRPs on the private rating letter and private rating letter rationale report or to influence the process as investors to encourage NAIC CRPs to provide the data-feeds to the SVO or alternative methods to permit the SVO to obtain NAIC CRP credit ratings and private rating letter rationale report for PL securities to be used to administer the PL securities verification procedure specified in this section.



PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

EXECUTIVE OFFICE • 444 North Capitol Street NW, Suite 700 • Washington, DC 20001-1509

p | 202 471 3990 f | 816 460 7493

CENTRAL OFFICE • 1100 Walnut Street, Suite 1500 • Kansas City, MO 64106-2197

p | 816 842 3600 f | 816 783 8175

CAPITAL MARKETS & INVESTMENT ANALYSIS OFFICE • One New York Plaza, Suite 4210 • New York, NY 10004

p | 212 398 9000 f | 212 382 4207

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

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PL SECURITIES

Effective Date of Verification Procedure for PL Securities

9. Effective January 1, 2022, for each PL security received by the SVO either through a copy of a private rating letter or in a CRP credit rating feed, insurance companies shall be responsible for providing the SVO a copy of the related private rating letter rationale report from the applicable NAIC CRP, 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.
10. 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.
11. 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 **PL GI** security).

Definitions

12. For purposes of this section:
 - The phrase “private rating letter” means a letter or report issued by an NAIC CRP on its letterhead or its controlled website to an issuer or investor, obtained by an insurer in its capacity as an investor in the issuance or by following the confidentiality process established by the NAIC CRP.
 - The phrase “privately rated security” means a security issued by an issuer wherein the issuer has solicited a credit rating for the issuance from an NAIC CRP and the NAIC CRP has agreed to issue a credit rating for the issuance to be communicated to the issuer and a specified group of investors only and not publicly released via the NAIC CRP’s public data feed or website. The privately rated security is the subject of the private rating letter and is referred to herein as a private letter (PL) security.

- The phrase “private rating letter rationale report” means an analytical review of the privately rated security explaining the transaction structure, methodology relied upon, and, as appropriate, analysis of the credit, legal and operational risks and mitigants supporting the assigned NAIC CRP rating, in a report issued by an NAIC CRP on its letterhead or its controlled website to an issuer or investor, obtained by an insurer in its capacity as an investor in the issuance or by following the confidentiality process established by the NAIC CRP.

Conditions to Filing Exemption for PL Securities Issued on or After January 1, 2018

13. **PL** securities are exempt from filing with the SVO for assignment of an analytically determined NAIC Designation if the security has been assigned an Eligible NAIC CRP Credit Rating, ~~and~~ the insurer verifies the rated status of the **PL** security to the SVO, ~~the insurer or NAIC CRP provides the SVO with the private rating letter rationale report, and the SVO concurs with the assigned Eligible NAIC CRP Credit Rating and the SVO deems the privately rated security eligible to receive an NAIC Designation with an NAIC CRP Credit Rating.~~
14. If the **PL** security is not rated by an NAIC CRP; or a credit rating is assigned that is not an Eligible NAIC CRP Credit Rating; or if the insurer cannot provide the SVO a private rating letter verifying that the assigned credit rating is an Eligible NAIC CRP Credit Rating; or the NAIC CRP cannot provide the Eligible NAIC CRP Credit Rating on the **PL** security to the NAIC through an electronic data feed approved by the SVO and that specifically identifies the **PL** securities rated by that NAIC CRP; ~~or the insurer or NAIC CRP cannot provide the private rating letter rationale report; or the SVO does not concur with the assigned Eligible NAIC CRP Credit Rating based on its review of the private rating rationale report;~~ or the SVO deems the privately rated security ineligible to receive an NAIC Designation with a NAIC CRP Credit Rating, the **PL** security is not filing exempt.
15. An insurer that owns a **PL** security that is not filing exempt shall either: (a) file the security with the necessary documentation with the SVO for an analytically determined NAIC Designation; or (b) self-assign an **NAIC 5GI** to the security and report using the Interrogatory procedure; in either case within 120 days of purchase.

Conditions to Filing Exemption for PL Securities Issued Prior to January 1, 2018

16. **PL** securities issued prior to January 1, 2018 are exempt from filing with the SVO for assignment of an analytically determined NAIC Designation if the security has been assigned an Eligible NAIC CRP Credit Rating. If the **PL** security CRP rating is not included in the applicable CRP credit rating feed (or other form of direct delivery from the CRP) or the insurer cannot submit the private letter rating to the SVO because of confidentiality provisions, the security shall be designated **PLGI**. Insurers shall report on all such securities in a General Interrogatory with an attestation that all such securities have an Eligible CRP Credit and are reflected in the financial statements and risk-based capital calculation commensurate with that rating

Procedure

17. The NAIC shall create systems and develop and staff administrative and operational procedures to be administered by the SVO to identify insurer-owned **PL** securities; verify whether or not the assigned credit rating is an Eligible NAIC CRP Credit Rating, review the private rating letter rationale report, and either translate that credit rating into its equivalent NAIC Designation and input the NAIC Designation for the security into the appropriate NAIC systems or notify the insurer that the security is not eligible for filing exemption.

SVO to Administer Verification Procedures

18. It shall be the responsibility of the NAIC to create and maintain for the SVO, electronic facilities to accept: (a) electronic data-feeds provided by NAIC CRPs containing and specifically identifying the **PL** securities rated by that NAIC CRP, ~~and~~ the credit rating assigned to the **PL** securities and the supporting private rating letter rationale report; or (b) PDF files of private rating letters provided by insurers to the SVO containing the NAIC CRP credit rating for the **PL** security and a copy of the supporting private rating letter rationale report.

The PL Process

19. It shall be the responsibility of the SVO to identify **PL** securities in the AVS+ system for insurance companies to use when reporting **PL** securities to the NAIC as part of the NAIC's Financial Statement Blank reporting process. The SVO identifies **PL** securities when it conducts the quarterly compilation of the SVO List of Securities.

Producing NAIC Designations for PL Securities

20. The SVO shall produce NAIC Designations for securities subject to private letter ratings as follows:

- The insurance company shall file a copy of the private rating letter with the SVO if not included in the applicable NAIC CRP Rating feed(s) (or other form of direct delivery from the CRP) noted above in Conditions to Filing Exemption for PL Securities and **the supporting private rating letter rationale report, if the SVO has not received it directly from the CRP, within the initial filing deadline for newly acquired securities or securities in transition (as explained in “SVO Analytical Department Symbols” in Part Two of this Manual) and each calendar year thereafter along with any changes in PL Securities rating.** In instances where the **PL** security is included in the applicable NAIC CRP Rating feed(s), the SVO shall follow the procedure for Filing Exempt (FE) securities **only after the SVO receives both the private rating letter and private rating letter rationale report either directly or through a NAIC CRP Rating feed(s), and if, in its sole discretion, it concurs with the assigned Eligible NAIC CRP Credit Rating after reviewing the private rating letter rationale report and the SVO** deems the privately rated security eligible to receive an NAIC Designation with an NAIC CRP Credit Rating.
- In instances where a private letter **and private rating letter rationale report** is filed, the SVO shall evaluate the private letter **and private rating letter rationale report** to determine whether the security has been assigned an Eligible NAIC CRP Rating **and if the privately rated security is eligible to receive an NAIC Designation with a NAIC CRP Credit Rating.** Similar to public securities where a rating is received directly from the CRP via electronic feeds, **there is a similar assumption for the PL security,** that the **rating** meets the definition of an Eligible NAIC CRP Rating as a normal part of the CRP rating process, absent evidence to the contrary in the rating letter **or private rating letter rationale report** (e.g., evidence that the rating applies only to principal or interest, in a deviation from the normal CRP rating process).
- If the SVO verifies that the security has been assigned an Eligible NAIC CRP Rating and **if the SVO, upon review of the private rating letter rationale report and in its sole discretion, concurs with the assigned Eligible NAIC CRP Credit Rating** deems the privately rated security eligible to receive an NAIC Designation with a **NAIC CRP Credit Rating,** it assigns an NAIC Designation in accordance with the policy and procedure specified in this Manual. The assumption in the application of this step of the procedure is that **PL** securities are typically assigned a credit rating by only one NAIC CRP. However, if this assumption is inaccurate for any **PL** security, the SVO applies the same procedure specified for FE securities.

21. If the SVO verifies that the security:

- Has been assigned a credit rating but that the credit rating is not an Eligible NAIC CRP Credit Rating; or
- Has not been rated by an NAIC CRP; or

- Is no longer subject to a private letter rating; or
- ~~Has an assigned Eligible NAIC CRP Credit Rating that the SVO, in its sole discretion, does not concur with; or~~
- Is a type of security that is ineligible to receive an NAIC Designation with a NAIC CRP Credit Rating

The SVO shall notify the insurer that the security is not eligible for filing exemption. The insurance company shall then either file that security and necessary documentation with the SVO for an independent credit assessment or assign an **NAIC 5GI** Regulatory Designation to the security in the related Interrogatory.

22. An **NAIC 5GI** Designation may also be used in connection with the designation of **PL** securities rated by an NAIC CRP (i.e., for private letter ratings issued on or after January 1, 2018) when the documentation is not available for the SVO to assign an NAIC Designation. For purposes of this section, the documentation is not available for the SVO to assign an NAIC Designation if the NAIC CRP credit rating is not included in the applicable CRP credit rating feed (or other form of direct delivery from the NAIC CRP) and the insurer is unable to provide a copy of the private letter rating documentation, **including the private rating letter rationale report**, necessary for the SVO to assign an NAIC Designation.

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