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


DATE: April 9, 2021

1. **Summary** – The IAO staff discussed with the Task Force at its May 14, 2020 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 Oct. 23, 2020 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 Nov. 14, 2020 the Task Force directed the SVO to make updates to the 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.

At the Task Force meetings on Feb. 18 and Mar. 22, 2021, the Task Force directed the SVO to make additional updates related to transition language to provide an option to companies that cannot provide the ratings rationale due to confidentiality or contractual reasons, and disclosures in NAIC systems as to why something was ineligible. There was also a discussion during the March meeting regarding the expected content of the private rating letter rationale reports. The SVO advised the Task Force at that meeting that rating agencies are in the business of publishing credit analysis opinions and should be very familiar with what they typically publish publicly for a specific asset type. Private ratings are supposed to be determined through the same methodologies as public ratings, the SVO stated that it is expecting a report comparable to what the rating agency would publish in its public reports for that asset type.
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 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 still recommends that it 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 Task Force has decided to defer its decision on this aspect of the recommendation.

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 (additions underlined and deletions with strikethrough) shows the proposed Purposes and Procedures Manual revisions and reflects all subsequent updates.
PART ONE

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

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FILING EXEMPTIONS

...
PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS
PROCEDURE APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL) RATING SECURITIES

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12. For (a) PL Securities issued from January 1, 2018 to December 31, 2021 subject to a confidentiality agreement executed prior to January 1, 2022, which confidentiality agreement remains in force, for which an insurance company cannot provide a copy of a private rating letter rationale report to the SVO due to confidentiality or other contractual reasons (“waived submission PLR securities”), the insurer may report such securities on such securities’ General Interrogatory (i.e., a PLGI security), and (b) PL Securities issued after January 1, 2022, for which an insurance company cannot provide a copy of a private rating letter rationale report to the SVO due to confidentiality or other contractual reasons (“deferred submission PLR securities”) the insurer may report such securities on such securities’ General Interrogatory (i.e., a PLGI security) until and including December 31, 2023, after which time, if the insurance company still cannot provide a copy of a private rating letter rationale report for whatever reason, the securities can be reported with an NAIC 5GI Designation in accordance with the guidance specified below.

Definitions

13. 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. A private rating letter rationale report should mirror the work product that a CRP would produce for a similar publicly rated security.
Conditions to Filing Exemption for PL Securities Issued on or After January 1, 2018

14. 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 (except for delayed submission PLR securities and waived submission PLR securities), and the SVO deems the privately rated security eligible to receive an NAIC Designation with an NAIC CRP Credit Rating.

15. 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 (except for delayed submission PLR securities and waived submission PLR securities); 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.

16. 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

17. 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

18. 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

19. 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

20. 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

21. 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 (so long as such rationale update would normally be produced by the CRP for a comparable publicly rated security) 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 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 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.

22. 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.
• 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.

If the SVO deems a security ineligible to receive an NAIC Designation per the instructions in this Manual because (a) the security is ineligible for Filing Exception according to “Specific Populations of Securities Not Eligible for Filing Exemption” in this Part or (b) the security is of a type outside the scope of SSAP No. 26R - Bonds, SSAP No. 32- Preferred Stock, or SSAP No. 43R – Loan Backed and Structured Securities then, for such a security, the SVO will provide a brief explanation in VISION, accessible to all VISION account holders, of why the security will not be provided an NAIC Designation.

23. 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 (a) 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, (b) for private letter ratings issued on or after January 1, 2022, an insurance company does not provide a copy of a private rating letter rationale report to the SVO for which there are no confidentiality or contractual limitations or (c) for deferred submission PLR securities, if the insurance company does not submit the private rating letter rationale report to the SVO on or after January 1, 2024.