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

 Members of the Valuation of Securities (E) Task Force

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

Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)

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RE: Clarify the Definition of an NAIC Designation in Parts One and Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*

DATE: September 30, 2022

**Summary:** As noted in Part One of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual), NAIC Designations and NAIC Designation Categories serve many purposes. NAIC Designations and other Securities Valuation Office (SVO) and Structured Security group (SSG) (collectively, the Investment Analysis Office (IAO)) products are standards identified in the NAIC Policy Statement and Financial Regulation Standards (SFRS) that states, as participants in the Accreditation Program administered by the Financial Regulation Standards and Accreditation (F) Committee, have incorporated into law. Part A of the SFRS identifies laws and regulations deemed necessary to financial solvency regulation, which includes, directly or indirectly, the analytical products of the IAO. These standards include the following:

* Standard 5 requires that insurer-owned securities be assessed in accordance with the standards promulgated by the NAIC IAO.
* Standard 2 refers to the NAIC Risk-Based Capital (RBC) for Insurers Model Act (#312) which assigns RBC factors for securities based on their credit risk as quantified by NAIC Designations.
* Standard 3 refers to the NAIC Accounting Practices and Procedures Manual, which uses NAIC Designations produced by the SVO and/or Price Grids produced by the SSG for statutory accounting purposes including to identify the valuation rules that apply to an investment.
* Standard 8 refers to state investment regulations which often incorporate NAIC model law provisions that relate asset allocations to credit quality or credit risk quantified by NAIC Designations.
* Standard 10 refers to the NAIC Credit for Reinsurance Model Law (#785), which refers to insurer-owned securities compiled by the SVO and identified on the List of Investment Securities, and in a separate provision, letters of credits issued by the banks and non-bank financial institutions whose name is placed on the NAIC List of Qualified U.S. Financial Institutions administered by the SVO, as eligible for use as collateral in reinsurance transactions.

These standards have been included in this memorandum to highlight the many ways in which NAIC Designations are used within NAIC guidance for different purposes. These varied uses in regulatory guidance also highlight why NAIC Designations differ from Credit Rating Provider (CRP) ratings. The current definition of an NAIC Designation in the P&P Manual does not clearly associate its use for these purposes and standards. The attached amendment proposes changes in Part One and Part Two of the P&P Manual to clearly articulate that the assignment of an NAIC Designation to a security considers and/or reflects the following:

* The likelihood of timely payment of principal and/or interest, as appropriate.
* The probability of default.
* The appropriateness and consistency of the risk-based capital model factor that will be applied to the security given its level of risk.
* 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.

**Recommendation:** The SVO recommends adoption of this proposed amendment updating the definition of an NAIC Designation in the P&P Manual to clearly link its use in the NAIC Policy Statement and Financial Regulation Standards (SFRS). The proposed text changes to P&P Manual are shown below with additions in red underline, deletions in ~~red strikethrough~~ as it would appear in the 2022 P&P Manual format.

## Part One: Policies of the NAIC Valuation of Securities (E) Task ForceABOUT THIS MANUAL

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#### **Expression of NAIC Standards in State Law and Regulatory Processes**

1. NAIC Designations and other SVO and SSG products are standards identified in the NAIC Policy Statement and Financial Regulation Standards (SFRS) that have been incorporated into state law by the States as participants in the Accreditation Program administered by the Financial Regulation Standards and Accreditation (F) Committee. Information about the F Committee and the Accreditation Program can be accessed here: www.naic.org/cmte\_f.htm.
2. Part A of the SFRS identifies laws and regulations deemed necessary to financial solvency regulation. Analytical products of the SVO and SSG [sometimes collectively called the Investment Analysis Office (IAO)] are directly or indirectly incorporated into SFRS Part A standards.
* Standard 5 requires that insurer-owned securities be assessed in accordance with the standards promulgated by the NAIC IAO.
* Standard 2 refers to the NAIC Risk-Based Capital (RBC) for Insurers Model Act (#312) which assigns RBC factors for securities based on their credit risk as quantified by NAIC Designations.
* Standard 3 refers to the NAIC Accounting Practices and Procedures Manual, which uses NAIC Designations produced by the SVO and/or Price Grids produced by the SSG for statutory accounting purposes including to identify the valuation rules that apply to an investment.
* Standard 8 refers to state investment regulations which often incorporate NAIC model law provisions that relate asset allocations to credit quality or credit risk quantified by NAIC Designations.
* Standard 10 refers to the NAIC Credit for Reinsurance Model Law (#785), which refers to insurer-owned securities compiled by the SVO and identified on the List of Investment Securities, and in a separate provision, letters of credits issued by the banks and non-bank financial institutions whose name is placed on the NAIC List of Qualified U.S. Financial Institutions administered by the SVO, as eligible for use as collateral in reinsurance transactions.
1. NAIC Designations and other analytical products of the SVO and SSG are produced solely for the benefit of NAIC members in their capacity as state insurance department officials for use in the NAIC Financial Regulation Standards and Accreditation Program as described above. To ensure NAIC members have a central source from which to obtain information about insurer-owned securities (including their NAIC Designations) the VOS/TF has identified the AVS+ Products as the depository for information compiled by the SVO in the SVO List of Investment Securities.

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#### **NAIC Designations**

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.
* An NAIC Designation reflects the likelihood of timely payment of principal and interest, as appropriate, and the probability of principal and interest payment default.
* An NAIC Designation reflects the appropriateness and consistency of the risk-based capital model factor that will be applied to the security given its level of risk.
* An NAIC Designation must be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS).
* 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.

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## Part TwoOperational and Administrative Instructions Applicable to the SVOProduction of NAIC Designations

### NAIC Designations

1. 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/TF in this Manual. NAIC Designations identify a category or band of credit risk that reflects the likelihood of timely payment of principal and interest, as appropriate, the probability of principal and interest payment default, and the appropriateness and consistency of its use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) including the risk-based capital model factor that will be applied to the security given its level of 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, the likelihood of timely payment and risk of payment default. 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.

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https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-10-20 - Interim Meeting/04-Definition of NAIC Designation Part Two/2022-012.01 P&P Definition of NAIC Desig.docx