



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

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RE: Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the "P&P Manual") Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

DATE: April 25, 2023

Summary: At the Spring National meeting held on Mar. 23, 2023, during the discussion of the proposed amendment on Structured Equity and Funds, the Task Force directed the SVO staff to draft a distinct process on how it would recommend challenging an NAIC Designation assigned from a credit rating provider ("CRP") rating in the Filing Exemption ("FE") process which the SVO thinks is not a reasonable assessment of risk for regulatory purposes. The Task Force deferred action on the Structured Equity and Funds amendment pending its review of such a CRP ratings review process.

As noted in "Policies Applicable to the Filing Exemption (FE) Process" in P&P Manual, Part One, paragraph 80:

The VOS/TF is resolved that the benefit obtained from the use credit rating in state regulation of insurance must be balanced against the risk blind reliance on credit ratings. To ensure the Task Force properly understands the composition and risk of the filing exempt securities population; promote uniformity in the production of NAIC Designations, reduce reporting exceptions for filing exempt securities and increase the efficiency of this NAIC process, the SVO and SSG (hereafter, the IAO) is charged with administration of the filing exempt process defined in Part Three of this Manual.

This amendment would grant the Securities Valuation Office staff some level of discretion over the FE process to address the NAIC's current blind reliance on credit ratings. It also addresses the Financial Condition (E) Committee's charge to the Task Force to:

Establish criteria to permit staff's discretion over the assignment of NAIC designations for securities subject to the FE process (the use of CRP ratings to determine an NAIC designation) to ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives.



In the attached amendment the SVO is proposing a process by which it would be authorized to challenge an FE calculated NAIC Designation. The process would include steps such as the following:

- A means to identify to insurers a FE calculated NAIC Designation of concern via AVS+.
- Sufficient notice to allow an insurer to appeal/provide additional information before any action is taken.
- A formal review process by the SVO, with an opportunity for applicable insurance regulator(s) to consult on the deliberation, if they request.
- Establishment of the materiality threshold required to remove a CRP rating or security from FE eligibility.
- A means to either deactivate the notice of concern or revoke FE eligibility.
- If FE eligibility is revoked, provide notice that a full filing is required.
- A means to re-instate the CRP rating or security to FE eligibility should changing conditions or ratings warrant.

Recommendation: The SVO recommends adoption of this proposed amendment authorizing the procedures for the SVO's discretion over NAIC Designations assigned through the FE process. 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 FORCE

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POLICIES APPLICABLE TO THE FILING EXEMPTION (FE) PROCESS

NOTE: The policies below provide the policy framework for “Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities” in Part Three and are related to “The Use of Credit Ratings of NRSROs in NAIC Processes” discussed above; “NAIC Policy on the Use of Credit Ratings of NRSROs” and the “Definition – Credit Ratings Eligible for Translation to NAIC Designations” in Part Two (“Eligible NAIC CRP Credit Ratings” excludes the use of any credit rating assigned to a security type where the NAIC has determined that the security type is not eligible to be reported on Schedule D or the it is not appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of the security or asset.)

Determinations

80. The VOS/TF is resolved that the benefit obtained from the use of credit ratings in state regulation of insurance (i.e. conservation of limited regulatory resources) must be balanced against the risk of blind reliance on credit ratings. To ensure the Task Force properly understands the composition and risk of the filing exempt securities population₅, promote uniformity in the production of NAIC Designations, reduce reporting exceptions for filing exempt securities and increase the efficiency of this NAIC process, the SVO and SSG (hereafter, the IAO) is charged with administration of the filing exempt process defined in Part Three of this Manual.

Directives

81. The IAO shall:

- Recommend improvements to the production of NAIC Designations based on NRSRO credit ratings.
- Identify monitoring and communication procedures that enhance the possibility of regulatory intervention by the VOS/TF to respond to risks to insurer solvency posed by securities in the filing exempt population.
- Identify and develop correctives to the administrative, operational and system-based causes of reporting exemptions in the filing exempt process.

- Change the NAIC Designation equivalent calculated for filing exempt securities when necessary to correct errors or other anomaly that occur in the automated filing exempt process.
- Develop a staff-administered reporting exceptions resolution process that incorporates state insurance regulator and insurance companies' participation.
- In furtherance of the above directives, exclude specific otherwise Eligible NAIC CRP Credit Ratings or remove securities from the automated filing exemption process in accordance with the administrative procedures outlined in Part Two of this Manual, if the IAO, following a self or state regulator initiated review, determines the resulting NAIC Designation equivalent does not provide a reasonable assessment of risk for regulatory purposes.

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PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS
APPLICABLE TO THE SVO

SVO ORGANIZATION

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SVO Administrative Symbols

153. SVO administrative symbols convey information about a security or an administrative procedure instead of an opinion of credit quality. The administrative symbols in use by the SVO and their meanings are described below.

SVO Analytical Department Symbols

154. All SVO analytical departments use the following administrative symbols:

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- REG means that the NAIC Designation is under analytical review by direction of a state insurance regulator.
- IAO means the NAIC Designation is under analytical review initiated by the NAIC's Investment Analysis Office.

PROCESS FOR PLACING A FILING EXEMPT SECURITY UNDER ANALYTICAL REVIEW FOR POSSIBLE REMOVAL FROM FILING EXEMPTION

Overview

164. This section outlines the process by which a state insurance regulator or IAO staff can contest an NAIC Designation assigned through the filing exemption process which it thinks is not a reasonable assessment of risk of the security for regulatory purposes. Following a notice period and optional appeal by the insurer security owner, the Eligible NAIC CRP Credit Rating or the security's filing exemption eligibility could be maintained or revoked. If revoked, the insurer would then have the option of filing the security with the SVO for assignment of an NAIC Designation. An insurer can appeal revocation in subsequent filing years.

Notice Period

165. The IAO shall identify any filing exemption-eligible security assigned an NAIC Designation equivalent through the automated filing exemption process as being a "Filing Exempt Security Under Analytical Review" if: (i) a state insurance regulator notifies the IAO that it has determined the NAIC Designation equivalent is not a reasonable assessment of risk of the security for regulatory purposes and the IAO agrees with that determination, or (ii) the IAO, in its opinion, determines that the NAIC Designation equivalent is not a reasonable assessment of risk of the security for regulatory purposes.

166. The IAO will notify insurance company holders of a security determined to be a Filing Exempt Security Under Analytical Review by publishing on the NAIC's AVS+ product a separate SVO Administrative Symbol of either "REG", if the determination was initiated by a state insurance regulator, or "IAO", if that the determination was initiated by the IAO, each indicating that the IAO may block the use of the otherwise Eligible NAIC CRP Credit Rating or remove the security from filing exemption upon completion of its review. The IAO shall make a determination of the Eligible NAIC CRP Credit Rating or security filing exemption status within 120 days from initial notice or at the conclusion of any outstanding insurer appeal, whichever is later.

167. The IAO will post on the NAIC's AVS+ product a notice that the security is a Filing Exempt Security Under Analytical Review along with the initial date of the notice and the indicative NAIC Designation Category based on the IAO's preliminary assessment. The notice will remain open for a period of 120-days during which time an insurer that owns the security may, consistent with the VOS/TF policy Review of SVO Determinations, submit an appeal of the posted indicative NAIC Designation Category determined through the Materiality Threshold for IAO Analytical Review, described below, by following the operational steps outlined in the Appeals of SVO Determinations in this Manual.

168. The IAO will also provide a notification to insurance regulators that the security is a Filing Exempt Security Under Analytical Review along with the initial date of the notice and the indicative NAIC Designation Category based on the IAO's preliminary assessment. The notice will remain open for a period of 120-days during which time any insurance regulator that has a company that owns the security may discuss the security with the IAO and share their opinion as to its risk before the IAO makes a determination.

Materiality Threshold for IAO Analytical Review

169. When determining whether a security should be a Filing Exempt Security under Analytical Review, the IAO will consider the materiality of the difference between the Eligible NAIC CRP Credit Rating used in the filing exempt process and the IAO's own assessment of the risk. The IAO may elect to put a security under analytical review only if it determines, based upon its review, that the Eligible NAIC CRP Credit Rating is three (3) or more notches different than the IAO's assessment (e.g. NAIC Designation Category 1.G versus 2.C).

170. As part of its review, the IAO may consider observable factors such as (i) a comparison to peers rated by different CRPs, (ii) consistency of the security's yield at issuance or current market yield to securities with equivalently calculated NAIC Designations rated by different CRPs, (iii) the IAO's assessment of the security applying available methodologies, and (iv) any other factors it deems relevant. The IAO may request additional documentation and data, as necessary, to conduct its review.

Expiration of the Notice Period and Filing Exemption Determination

171. No later than 120 days after a security is marked as a Filing Exempt Security Under Analytical Review or following the conclusion of any outstanding appeal, whichever is later, the IAO Credit Committee, in its opinion and discretion, and in consultation with the applicable state insurance regulator(s), if requested, will make a final determination of whether the Eligible NAIC CRP Credit Rating or security should be removed from Filing Exemption eligibility.

172. If the IAO determines that the NAIC Designation Category assigned pursuant to the Filing Exemption process shall remain unchanged, the Eligible NAIC CRP Credit Rating or security shall remain eligible for Filing Exemption, the Filing Exempt Security Under Analytical Review notification will be deactivated and no further action will be taken at that time. The IAO's determination to maintain the filing exemption eligibility of an Eligible NAIC CRP Credit Rating or security shall not preclude the IAO from placing the same Eligible NAIC CRP Credit Rating or security under analytic review at a later date following a subsequent review should changing conditions warrant.

173. If the IAO determines the Eligible NAIC CRP Credit Rating or security should be removed from Filing Exemption eligibility, the IAO will add the Eligible NAIC CRP Credit Rating or security to NAIC systems with a notice to insurers that either the Eligible NAIC CRP Credit Rating or the security is not eligible for Filing Exemption and prevent it from utilizing the automated Filing Exempt Securities Process. An insurer that is concerned the IAO did not make its Filing Exemption determination regarding the insurer's security in accordance with the procedures in this Manual may request consideration of the concern by the VOS/TF pursuant to "Review of SVO Decisions by the VOS/TF" in this manual.

Assignment of NAIC Designation Category

174. For assignment of an NAIC Designation Category by the IAO to a security removed from Filing Exemption eligibility according to this section, the security would then need to be filed with the IAO according to the procedures outlined in this manual or through sufficient information having been submitted to the IAO through the Appeals of SVO Determinations, if there was one. If an Eligible NAIC CRP Rating has been removed from Filing Exemption eligibility according to this section and the security has another Eligible NAIC CRP Rating which has not been removed, then the security can receive its new NAIC Designation through the Filing Exemption process.

Reinstatement of Filing Exemption Eligibility

174. If an insurer would like the IAO to re-evaluate an Eligible NAIC CRP Credit Rating or security that was removed from Filing Exemption Eligibility for possible reinstatement in a subsequent filing year, it can follow the operational steps outlined in Appeals of SVO Determinations in this Manual to submit the request.

Reporting Securities Removed from Filing Exemption Eligibility

175. The Chair of the VOS/TF may request the IAO Director(s) to prepare a confidential, regulator-only report to be presented annually to the VOS/TF members, summarizing the Eligible NAIC CRP Credit Ratings and securities removed from Filing Exemption Eligibility over the prior calendar year and the reason for the removal.

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PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

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

Note: See “Use of Credit Ratings of NRSROs in NAIC Processes” and “Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force” (especially “NAIC Designations Do Not Communicate Statutory Accounting or Reporting” and “Policies Applicable to the Filing Exemption (FE) Process”) in Part One; “NAIC Policy on the Use of Credit Ratings of NRSROs” (especially “Definition – Credit Ratings Eligible for Translation to NAIC Designations”) in Part Two (the definition excludes the use of NAIC CRP credit ratings assigned to a security type where the NAIC has determined that the security type is not eligible to be reported on Schedule D or the it is not appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of the security or asset, as specified in this Manual); and “Filing Exemption Status of RMBS and CMBS” in Part Four (excluding RMBS and CMBS from the use of credit ratings for NAIC regulatory processes).

FE SECURITIES

Filing Exemption

3. Bonds, within the scope of SSAP No. 26R and SSAP No. 43R (excluding RMBS and CMBS subject to financial modeling) and Preferred Stock within scope of SSAP No. 32, that have been assigned an Eligible NAIC CRP Rating, as described in this Manual, are exempt from filing with the SVO (FE securities) with the exception of Bonds and/or Preferred Stock explicitly excluded below.

Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:
 - ...
 - **Securities Deemed Ineligible for Filing Exemption at the Conclusion of the Process for Placing a Filing Exempt Security Under Analytical Review for Possible Removal from Filing Exemption in Part Two of this Manual – For securities placed under analytic review by the IAO, if at the conclusion of the IAO Credit Committee’s deliberation the IAO determines the security should remain eligible for Filing Exemption, the Filing Exempt Security Under Analytical Review notification will be deactivated and no further action taken will be taken. If the IAO determines the security should be removed from Filing Exemption eligibility, the IAO will add the security to NAIC systems with a notice to insurers that the security is not eligible for filing exemption and prevent it from utilizing the automated Filing Exempt Securities Process.**

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/Work-in-Progress/SVO Discretion/2023-005.01 P&P SVO Discretion.docx>