



MEMORANDUM

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

FROM: Charles Therriault, Director, NAIC Securities Valuation Office
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CC: Jeff Johnston, Managing Director, NAIC Financial Regulatory Affairs
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DATE: February 27, 2020

RE: Issue Paper – IAO staff concerns about Bespoke Securities, and Reliance on CRP Ratings

1. **Introduction** – During the Task Force’s May educational session, the IAO staff discussed with the Task Force its growing concern with bespoke securities - financial instruments typically constructed by or for a small group of investors, which, due to their private nature, are not subject to or constrained by market forces and competition. As such, their visible characteristics may substantially underrepresent actual risks. We highlighted specific securities to the Task Force as part of our growing concern about what we believe is the NAIC’s excessive reliance on credit rating provider (CRP) ratings to assess investment risk for regulatory purposes. During the session, the Task Force members that participated agreed with these concerns, noting that it would be beneficial for the IAO staff to develop guidance for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) that would allow the IAO staff to flag certain bespoke transactions and in turn create a process that would either dissuade industry’s use of such transactions or limit the risk. While some regulators suggested technology solutions be developed that allow regulators to follow-up with insurers on flagged transactions, most of the regulators questioned their own ability to do so given existing time constraints and the likely expertise needed to analyze the securities and communicate with insurers on each such issue. During that session, the regulators suggested IAO staff develop a summary of the issues and make recommendations to remediate them. This memorandum serves that purpose and builds upon specific direction given to the IAO by the Task Force at the Summer National Meeting held on August 4, 2019, to prepare an issue paper outlining the risks posed by bespoke securities after the IAO’s presentation on this issue at that meeting and make recommendations to mitigate these risks along with the interrelated issue of relying upon CRP ratings.
2. **Analytical Concern** –
 - a. Bespoke securities - The term “bespoke” made its way to finance from the world of London tailors producing “made to measure” suits for their banking clients. For the following reasons these customized financial instruments are typically not constrained by market forces and competition and, as a result, may substantially underrepresent risk:
 - i. These securities are usually not broadly syndicated (i.e. not owned by many parties).
 - ii. They are created by or for one or a few related insurance companies as an investment.

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- iii. They are assigned a credit rating by only one NAIC CRP, often via a private rating.
- iv. Participants often deliberately keep the terms and structure private.

As we mentioned in our presentation, bespoke securities, by definition, exhibit a great deal of flexibility in form making them, as a category, very difficult to describe, beforehand (i.e. they can include all possible variations). Since these are “one-off” and often private securities, no third-party lists or data exist that are sufficient to identify them in any insurer portfolios. Even if they were clearly identifiable, the SVO currently staff lacks the authority to act upon any issues or concerns it may have when, in its opinion, a security or a CRP rating incorrectly reflects how NAIC guidance would treat or view that security.

- b. Reliance on CRP ratings – The Task Force’s use of CRP ratings to determine an NAIC designation pursuant to the filing exempt (FE) policy, and the related historically permitted practice of allowing private ratings for this same purpose, has evolved into the current situation where the NAIC has very little oversight over the use and analytical basis of the CRP ratings being used to assess risk for the vast majority of insurer investments. The NAIC relies on nine different CRPs today with a tenth CRP in the process of being added and other entities considering becoming an U.S. Securities and Exchange Commission (SEC) nationally recognized statistical ratings organization (NRSRO), a necessary step before becoming a CRP to the NAIC. As direct competitors, each rating entity employs different methodologies and processes that make their ratings product unique. The SEC monitors compliance with those processes and adherence to those methodologies but they do not opine on the quality or veracity of the methodologies or their applicability for NAIC purposes.

The Task Force has not required the SVO to monitor CRP ratings or their methodologies for consistency and applicability and the SVO has not been authorized to use its judgement to determine how and when, if at all, a CRP rating should be used for NAIC purposes. We believe this lack of staff oversight has enabled the increased use of bespoke securities and, more importantly, has permitted a very significant population of securities to be assigned NAIC designations through the FE process (~82% of all securities owned by insurers) based on methodologies that are currently unmonitored by the NAIC as to how risk is being assessed for regulatory purposes and how the security complies with NAIC policies. While we believe that the CRPs follow their published methodologies, as required by the SEC, we do not believe that every rating agency methodology is appropriate for, or consistent with, the assessment of investment risk for statutory purposes. The Credit Rating Agency Reform Act of 2006 (CRARA) requires NRSROs to make certain information public to help users of credit ratings compare NRSROs and assess their credibility. The philosophy behind the CRARA regulation of NRSROs is disclosure and “buyer beware”. In keeping with the intent of CRARA, we believe the NAIC, as a consumer of CRP ratings, needs to actively apply its own judgement in how it uses CRP ratings. This is also consistent with the recommendations made by the Rating Agency (E) Working Group that were subsequently adopted by the Financial Condition (E) Committee in the Working Group’s final report dated April 28, 2010 (excerpts of which are included in this paper and the full report accompanies it). The CRPs have thousands of methodologies between them; managing and administering their appropriate use for NAIC purposes would require the SVO to be given additional authority and discretion from the Task Force.

Concerns about inflated CRP ratings are not unique to the NAIC. For example, a letter from a bipartisan group of Senators to the SEC cited a Wall Street Journal article discussing a rating agency practice of changing methodology to gain business. The letter noted that the CRPs “have changed their rating criteria in ways that were followed by big jumps in market shares...”

3. Recommendations –

- a. Bespoke securities “Red Flags” – For any security that trips one or more of the following “red flag” criteria, the SVO would require its legal agreements submitted to the SVO so the SVO could assess whether the security

and/or the CRP rating were appropriate for NAIC purposes. If the SVO deemed the security acceptable but not the CRP rating, the security would need to be filed with the SVO for a complete analysis. If the SVO deemed the security unacceptable, the SVO would work with the appropriate regulatory groups to address any policy matters.

- i. Rating from a single CRP. At least two independent CRP ratings would be required for any NAIC designation to be derived from CRP ratings and the lower of the ratings would be applied. In the absence of two CRP ratings, the security would need to be filed for analysis by the SVO.
 - ii. Private letter rating. The analysis supporting the assignment of any private rating would need to be submitted to the SVO for review. The SVO would have the authority to determine if it would rely upon the private rating or require the security to be filed. The analysis would need to be provided at least annually.
 - iii. Assets backing the security were primarily owned by insurer or affiliates before the transaction and reported differently (i.e. regulatory arbitrage)
 - iv. Assets backing the security do not generate bond-like cash flows (i.e. contractual requirements to pay periodic principal and interest).
 - v. Insurer or affiliated group are sole investors in security
 - vi. Affiliate of company is underwriter or sponsor of the security
- b. Reliance on CRP ratings – The SVO would be tasked with monitoring CRP ratings and methodologies on a case-by-case basis and determining how they are used in the filing exemption process. The production of NAIC designations using CRP ratings is already an SVO administrative responsibility. Authorizing the SVO to oversee the applicability of those CRP ratings would add much needed oversight to the NAIC’s use of CRP ratings. . One of stated objectives of the NAIC’s use CRP ratings should be to achieve the greatest consistency and uniformity in the production of NAIC designations while maximizing the alignment between the assessment of investment risk to the NAIC’s statutory objectives.

4. **Recommendations of the Rating Agency (E) Working Group (“RAWG”)** - The risks and concerns being highlighted in this paper echo those identified in the final report of the Rating Agency (E) Working Group (“RAWG”) dated April 28, 2010, and the recommendations above are consistent with the Working Group’s that were also adopted by the Financial Condition (E) Committee; some of which are listed below in italics (the full report is attached):

a. *Summary of Recommendations*

The Working Group recommends that:

- i. *Regulators explores how reliance on ARO ratings can be reduced when evaluating new, structured or alternative asset classes, particularly by introducing additional or alternative ways to measure risk;*
- ii. *Consider alternatives for regulators’ assessment of insurers’ investment risk, including expanding the role of the NAIC Securities Valuation Office (“SVO”); and*
- iii. *When considering continuing the use of ratings in insurance regulation, the steps taken by the NRSROs in correcting the causes that led to recent rating shortfalls, including the NRSROs’ efforts in implementing the recommended structural reforms, should be take into account.*

... (VOS recommendations) ...

- b. *VOS should study the use of ratings in the financial solvency monitoring of insurance companies to confirm it ratings should differ for municipal, corporate and structured securities as general asset classes. Consideration should also be given to applying ratings differently within segments of these broader categories.*

- c. *An evaluation should be made to determine whether the differences between ratings for municipal and other securities is material enough to warrant change how ARO ratings are converted into NAIC designations.*
- d. *VOS should continue to develop independent analytical processes to assess investment risks. These mechanisms can be tailored to address unique regulatory concerns and should be developed for use either as supplements or alternatives to ratings, depending upon the specific regulatory process under consideration.*
- e. *ARO ratings have a role in regulation; however, since the ratings cannot be used to measure all the risk that a single investment or a mix of investments may represent in an insurer's portfolio, NAIC policy on the use of ARO ratings should be highly selective and incorporate both supplemental and alternative risk assessment benchmarks.*
- f. *NAIC should evaluate whether to expand the use of SVO and increase regulator reliance on the SVO for evaluating credit and other risks of securities.*
- g. *The NAIC Rating Agency (E) Working Group should establish a process to monitor and evaluate ARO activities. A monitoring function would:*
 - i. *Provide information about product offerings and the direction of financial innovation.*
 - ii. *Permit timely regulatory intervention to set regulatory treatment of risk securities differently than that suggested by their credit quality.*
 - iii. *Promote, if not require, rating agency transparency of process, compensation, staff participation, and collateral underlying the security.*
 - iv. *Determine the materiality of risks other than credit to financial solvency.*
 - v. *Monitor and assess the changes that ratings agencies are implementing, and whether ratings continue to correctly complement regulatory purposes.*
- h. *The SVO does not take part in the structuring of securities transactions for issuers and is not subject to the competitive pressure that can lead to the conflicts of interest discussed throughout this report; therefore, state regulators should evaluate whether to expand the SVO's role.*
- i. *Modify the Filing Exempt Rule:*
 - i. *VOS should consider developing alternative methodologies for assessing structured security risks. Those structured security classes where an alternative method is adopted would be ineligible for filing exemption.*
 - ii. *VOS should consider if new investment productions should be ineligible for filing exemptions and/or instead be subject to regulatory evaluation. Filing exempt status can be granted or withheld on the basis of the regulatory review.*
 - iii. *VOS should study the use of ratings in the financial solvency monitoring of insurance companies to confirm if ratings should differ for municipal, corporate and structured securities as general asset classes. Consideration should also be given to applying ratings differently within segments of these broader categories.*

- iv. *Consideration should be given to modifying the filing exempt rule to adjust for securities with new additional ARO ratings and other measures (such as V Scores and Parameter Sensitivities) when deemed applicable. The need for difference RBC and/or some other and additional regulatory process should be evaluated. Such processes could include the use of market information on price direction and of yield trends in addition to ARO ratings for some or all filing exempt securities.*

Securities highlighted by this process can be reviewed by the SVO with the objective of adjusting the ARO rating to help ensure an accurate RBC charge.

- v. *VOS should develop tools to better address market and liquidity risk in structured securities*

- 5. **Next steps** – The IAO recommends sharing the issue paper with Financial Condition (E) Committee to alert them to these continuing risks highlighted in the Rating Agency (E) Working Group’s recommendations and continuing this discussion next year.

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