



MEMORANDUM

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

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office

CC: Charles Therriault, Director, NAIC Securities Valuation Office
Eric Kolchinsky, Director, NAIC Structured Securities Group

DATE: March 29, 2018

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) – Delete Instructions for Classification of Preferred Stock as Redeemable or Perpetual and the Administrative Symbols RP or P

1. Introduction – The SVO recommends the deletion of the SVO assignment and the related methodology and administrative symbols (P and RP called Valuation Indicators) used to classify shares of preferred stock as redeemable or as perpetual. The recommendation follows the Task Force’s Feb. 28, 2018, approval of a related change to reporting instructions in the comprehensive Blanks Proposal and Interrogatory (Item 2008-07BWG on the agenda of the Blanks (E) Working Group) to replace the SVO methodology and symbols with an instruction that the insurer aggregate the amount of such securities on a new specified line. The amendment would remove the process from the P&P Manual. The methodology requires the assessment of the governing agreement to determine if the issuer is obligated to redeem the issue or if the insurer has a right to put (or has a contractual equivalent) the preferred stock to the issuer. If the insurer has this right, the preferred stock is classified as redeemable and identified with the symbol RP; if not, the preferred stock is classified as perpetual and identified with the symbol P. The methodology and symbols support the implementation of valuation rules in *Statement of Statutory Accounting Principle (SSAP) No. 32—Preferred Stock*. (Please see SSAP No. 32, paragraph 15 and paragraph 16.) As discussed in connection with the Blanks Proposal and Interrogatory, most preferred stock purchased by insurers are filing exempt (FE). The small non-FE preferred stock population does not justify an SVO assignment because insurers already need to make the necessary analytical distinction when reporting FE preferred stock.

2. Text to be Deleted – The text to be deleted is shown by strikethrough below.

Section 3. Internal Administration

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b) Definitions of NAIC Designation Categories, Valuation Indicators, Administrative Symbols and Conventions

(i) Definition of NAIC Designation Categories

NAIC Designations are proprietary symbols that the NAIC SVO uses to denote a category or band of credit risk.

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NAIC Designations are adjusted in accordance with the notching procedures described in subparagraph (iii) (A), (B) and (C) below, so that an NAIC Designation for a given security reflects the position of that specific security in the issuer's capital structure.

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 subparagraph (ii) and (iii) (C) below.

~~When applied to preferred stock, the valuation indicator **P** is placed in front of the NAIC Designation to indicate that the SVO has classified the security as a perpetual preferred stock. The valuation indicator **RP** is placed in front of the NAIC Designation to indicate that the SVO has classified the security as a redeemable preferred stock for the purposes of valuation under SAP.~~

NAIC 1 is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer's credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An NAIC 1 obligation should be eligible for the most favorable treatment provided under the NAIC Financial Conditions Framework.

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~~(iv) Valuation Indicators~~

~~Pursuant to Part Three, Section 1(b) of this Manual, SVO is required to classify preferred stock as either perpetual or redeemable. Valuation Indicators show the classification decision of the SVO and are to be used by insurers to determine a SAP valuation method for preferred stock.~~

~~**P** means perpetual and is a valuation indicator used to classify a preferred stock as perpetual, pursuant to Part Three, Section 1(b) of this Manual. The valuation indicator **P** means that the issuer of the preferred stock is not obligated to redeem the issue, the holder of the preferred stock does not have a right to put the preferred stock to the issuer or that there is no other equivalent right. The P valuation indicator is assigned for the purposes outlined in SSAP No. 32—Preferred Stock.~~

~~**RP** means redeemable preferred and is a valuation indicator that classifies a preferred stock as a redeemable preferred stock pursuant to Part Three, Section 1(b) of this Manual. This means that the issuer of the preferred stock is obligated to redeem the issue, the holder of the preferred stock has a right to put the preferred stock to the issuer or that there is some other equivalent right. The **RP** valuation indicator is assigned for the purposes outlined in SSAP No. 32—Preferred Stock.~~

Part Three

c) General Procedure for Credit Assessment and Classification of Preferred Stock

The following provisions apply to all preferred stock subject to notching to reflect its position in the issuer's capital structure pursuant to Part One, Section 3 (b) (iii) (B) of this Manual.

(i) Preferred Stock Not Rated By an NAIC CRP

(A) *Determining an NAIC Designation*

The analyst shall first ascertain the senior unsecured debt rating of the issuer by applying the credit assessment procedure for bonds specified in Section 1(a) of this Part. Once the issuer's senior unsecured NAIC Designation has been established, the analyst will adjust the associated NAIC Designation to reflect:

- (1) The position of the preferred stock in the capital structure of the issuer;
- (2) A determination that the debt level in the issuer's capital structure would, or would not impede the ability of the issuer to pay interest or dividends to the preferred stock holder, and whether earnings are likely to be

sufficient to pay such interest or dividends (whether or not the issuer is contractually obligated to make such payments); and

(3) Whether all preferred dividends have been paid or sinking fund requirements have been met for the last three years. If not, the analyst shall not assign an **NAIC 1, 2 or 3** Designation to the preferred stock.

Once these adjustments have been considered, the analyst shall then determine and assign the most appropriate NAIC Designation to the preferred stock.

~~(B) — Classification of Preferred Stock~~

~~The analyst shall review the terms and underlying characteristics of the security. If the issuer is required to redeem the security or the holder has an irrevocable put or the terms of the security contain another provision to the same effect, the security shall be eligible for an **RP** valuation indicator. If the security does not contain a mandatory redemption, an irrevocable put or another provision to the same effect, the security shall be eligible for a **P** valuation indicator. The final classification decision made by the SVO shall be influenced by the degree of synergy between different provisions or characteristics of a security, the regulatory objectives of the NAIC and the SVO's exercise of analytical discretion. The **RP** and **P** valuation indicators are assigned for the purposes outlined in SSAP No. 32 — Preferred Stock.~~

(ii) Preferred Stock Rated by an NAIC CRP

(A) *Determining an NAIC Designation*

(1) Rated Preferred Issue

If the preferred stock is rated by an NAIC CRP, the SVO shall note the equivalent NAIC Designation for the issue and then apply the instructions outlined in [Section 1\(c\)\(i\)\(A\)\(2\) and \(3\) of this Part above](#). If necessary, the analyst shall adjust the NAIC Designation equivalent to the NAIC CRP rating as is appropriate. If no adjustment is deemed necessary to the NAIC Designation equivalent to the NAIC CRP rating, the analyst shall assign the NAIC Designation equivalent to the NAIC CRP rating to the preferred stock as provided for in [Part One, Section 4 \(c\) \(ii\) of this Manual](#).

(2) Issuer Rated, Preferred Issue Not Rated

The analyst may determine the issuer's senior unsecured designation by converting the rating assigned by the NAIC CRP to the issuer's outstanding debt into an equivalent NAIC Designation. Once the senior unsecured designation level has been established, the analyst may adjust the NAIC Designation associated with the issuer's senior unsecured designation level by applying the instructions outlined in [Section 1\(c\)\(i\)\(A\)\(2\) and \(3\) of this Part above](#), to the unrated preferred stock. The analyst shall then determine the most appropriate NAIC Designation and apply the NAIC Designation to the preferred stock.

(3) Issuer Rated, With Other Preferred Stock Rated

The analyst may determine an NAIC Designation for an unrated preferred by comparing the unrated preferred stock with the outstanding rated preferred stock. The analyst will make such adjustments as are necessary to account for dissimilar features in the two securities and shall also apply the instructions discussed in [Section 1\(c\)\(i\)\(A\)\(2\) and \(3\) of this Part above](#), to the unrated preferred stock. The analyst shall then determine the most appropriate NAIC Designation and apply the NAIC Designation to the preferred stock.

~~(B) — Classification of Preferred Stock~~

~~The analyst shall apply the procedure discussed in [Section 1\(c\)\(i\)\(B\) of this Part above](#) to classify the preferred stock with either an **RP** or **P** valuation indicator.~~