NAIC 2023 FALL NATIONAL MEETING ORLANDO

Draft date: 11/3/2023

2023 Fall National Meeting
Orlando, Florida

VALUATION OF SECURITIES (E) TASK FORCE
Saturday, December 2, 2023
12:45 p.m. – 1:45 p.m. ET
Floridian Ballroom J-L & Corridor III - Level 1 - Bonnet Creek

ROLL CALL

Member	**Representative**	**State**
Doug Ommen, Chair	Carrie Mears	Iowa
Eric Dunning, Vice Chair	Lindsay Crawford	Nebraska
Mark Fowler	Sheila Travis	Alabama
Lori K. Wing-Heier	Jeffrey Bethel	Alaska
Ricardo Lara	Laura Clements	California
Andrew N. Mais	Ken Cotrone	Connecticut
Michael Yaworsky	Carolyn Morgan	Florida
Dean L. Cameron	Eric Fletcher	Idaho
Dana Popish Severinghaus	Vincent Tsang	Illinois
Vicki Schmidt	Tish Becker	Kansas
James J. Donelon	Stewart Guerin	Louisiana
Kathleen A. Birrane	Matt Kozak	Maryland
Gary D. Anderson	John Turchi	Massachusetts
Grace Arnold	Fred Andersen	Minnesota
Chlora Lindley-Myers	Debbie Doggett	Missouri
D.J. Bettencourt	Jennifer Li	New Hampshire
Justin Zimmerman	John Sirovetz	New Jersey
Adrienne A. Harris	James Everett	New York
Jon Godfread	Matt Fischer	North Dakota
Glen Mulready	Diane Carter	Oklahoma
Michael Humphreys	Diana Sherman	Pennsylvania
Carter Lawrence	Trey Hancock	Tennessee
Cassie Brown	Amy Garcia	Texas
Jon Pike	Jake Garn	Utah
Scott A. White	Doug Stolte	Virginia
Mike Kreidler	Steven E. Drutz	Washington
Nathan Houdek	Amy Malm	Wisconsin

NAIC Support Staff: Charles Therriault/Marc Perlman

AGENDA

Discuss and Consider for Adoption:

1. Consider Adoption of its Summer National Meeting (Doc. ID 2023-011.01)
—Carrie Mears (IA) — Attachment One

Hear a Staff Report:

2. The History of Filing Exemption (Doc. ID: 2023-012.01)
—Marc Perlman (NAIC) — Attachment Two

Receive, Discuss and Consider for Exposure or Referral:

3. Referral from SAPWG Schedule BA Proposal for Non-Bond Debt Securities (Doc. ID: 2023-013.01, 2023-013.02)
—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC) — Attachment Three; Attachments Three - A

4. Revised Proposed P&P Manual Amendment to Update the Definition of an NAIC Designation (Doc. ID: 2022-012.08 / Appendix: 2022-012.05, 2022-012.06, 2022-012.06b, 2022-012.07, 2022-012.08)
—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC) — Attachment Four; Appendix Four

5. Revised Proposed P&P Manual Amendment Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process (Doc. ID: 2023-005.15 /Appendix: 2023-005.01, 2023-005.02, 2023-005.03, 2023-005.04, 2023-005.05, 2023-005.06, 2023-005.07, 2023-005.08, 2023-005.09, 2023-005.10, 2023-005.11, 2023-005.12, 2023-005.13, 2023-005.14)
—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC) — Attachment Five; Appendix Five

6. Proposed P&P Manual Amendment to Add Practical Expedient to Determine the Issue Date for PLR filings (Doc. ID: 2023-014.01)
—Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC) — Attachment Six

Hear Staff Reports:

7. Updates on the Proposed CLO Modeling Methodology and Ad-hoc Working Group
—Eric Kolchinsky (NAIC)

8. Receive a Report on the Projects of the Statutory Accounting Principles (E) Working Group
—Carrie Mears (IA) and Julie Gann (NAIC)

9. Adjournment

Draft Pending Adoption

Draft: 8/28/23

Valuation of Securities (E) Task Force
Seattle, Washington
August 14, 2023

The Valuation of Securities (E) Task Force met in Seattle, WA, Aug. 14, 2023. The following Task Force members participated: Doug Ommen, Chair, represented by Carrie Mears (IA); Eric Dunning, Vice Chair, represented by Lindsay Crawford and Nolan Beal (NE); Lori K. Wing-Heier represented by David Phifer (AK); Mark Fowler represented by Sheila Travis (AL); Ricardo Lara represented by Laura Clements (CA); Andrew N. Mais represented by Kenneth Cotrone and Wanchin Chou (CT); Michael Yaworsky represented by Carolyn Morgan and Bradley Trim (FL); Dean L. Cameron represented by Eric Fletcher (ID); Dana Popish Severinghaus represented by Vincent Tsang (IL); Vicki Schmidt represented by Tish Becker (KS); James J. Donelon represented by Stewart Guerin (LA); Gary D. Anderson represented by John Turchi (MA); Kathleen A. Birrane represented by Matt Kozak and Lynn Beckner (MD); Grace Arnold represented by Fred Andersen (MN); Chlora Lindley-Myers represented by Debbie Doggett (MO); Jon Godfread represented by Matt Fischer (ND); D.J. Bettencourt represented by Jennifer Li (NH); Justin Zimmerman represented by John Sirovetz (NJ); Adrienne A. Harris represented by Bob Kasinow and Jim Everett (NY); Glen Mulready represented by Diane Carter and Ryan Rowe (OK); Carter Lawrence represented by Trey Hancock (TN); Cassie Brown represented by Amy Garcia and Jamie Walker (TX); Jon Pike represented by Jake Garn (UT); Scott A. White represented by Doug Stolte and Greg Chew (VA); and Nathan Houdek represented by Amy Malm (WI). Also participating was: Elizabeth Kelleher Dwyer (RI).

1. Adopted its July 13, May 15, and Spring National Meeting Minutes

Mears said the first item is to consider adoption of the Task Force's July 13, May 15, and Spring National Meeting minutes. There were a couple of non-substantive editorial items identified that will be corrected. Mears asked for a motion to adopt the minutes from the Task Force's July 13, May 15, and Spring National Meeting.

Crawford made a motion, seconded by Clements, to adopt the Task Force's July 13 (Attachment One), May 15 (Attachment Two), and March 23 (*see NAIC Proceedings – Spring 2023, Valuation of Securities (E) Task Force*) minutes. The motion passed unanimously.

2. Adopted its 2024 Proposed Charges

Mears said the next item is to consider the Task Force's 2024 proposed charges, which are unchanged from 2023.

Doggett made a motion, seconded by Malm, to adopt the Task Force's 2024 proposed charges (Attachment Three). The motion passed unanimously.

3. Received a Report on the Projects of the Statutory Accounting Principles (E) Working Group

Mears said the next item is to hear a report on projects before the Statutory Accounting Principles (E) Working Group.

Jake Stultz (NAIC) said the Working Group adopted several items and briefly discussed several items interest to the Task Torce. First, the Working Group adopted the majority of the items from the Principles-Based Bond Project, including revisions to the *Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds*,

Draft Pending Adoption

SSAP No. 43R—Loan-Backed and Structured Securities, and several other SSAPs that were affected by the changes. This effectively changes the Principles-Based Bond Definition for bonds, which includes issuer credit obligations and asset-backed securities (ABS). The changes are effective Jan. 1, 2025. Stultz explained that as part of the same project, the Working Group exposed revisions to *SSAP No. 21R—Other Admitted Assets* to provide guidance for accounting for debt securities that do not qualify as bonds and provide proposed measurement guidance for residuals. The exposure also includes the updated issue paper that details the discussions and development of this guidance. The Working Group would also sponsor a Blanks proposal to revise Schedule BA, and it will send a formal notice to the Task Force and the Capital Adequacy (E) Task Force on the proposal to allow life reporting entities the ability to use existing Schedule BA reporting provisions for Securities Valuation Office (SVO)-assigned designations in determining risk-based capital (RBC) for debt securities that do not qualify as bonds.

Stultz mentioned an item that he explained is less investment-related but has been a major focus within the NAIC over the previous year. The Working Group adopted *Interpretation (INT) 23-01: Net Negative (Disallowed) Interest Maintenance Reserve*, which provides optional limited-time guidance that allows the admittance of net negative disallowed interest maintenance reserve (IMR) up to 10% of adjusted capital and surplus. INT 23-01 will be effective until Dec. 31, 2025, and it will automatically be nullified on Jan 1, 2026, but the effective date can be adjusted. In addition, the Working Group directed the formation of an ad hoc subgroup to work on a long-term solution to the issue.

The Working Group also re-exposed agenda item 2023-11-EP: AP&P Manual Editorial Updates, which provides for revisions to clarify the scope and reporting of investment structures and residual interest, primarily limited partnerships, joint ventures, and other equity fund investments. The agenda item is primarily focused on *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies investments*. There were two additional items adopted by the Working Group: 1) revisions to *SSAP No. 34—Investment Income Due and Accrued*, which clarifies and incorporates a practical expedient to the paid-in-kind interest aggregate disclosure in SSAP No. 34 and *Annual Statement Instructions*; and 2) revisions to SSAP No. 43R to incorporate changes to add collateralized loan obligations (CLOs) to the financial modeling guidance and clarify that CLOs are not captured as legacy securities.

Lastly, Stultz noted that the Working Group will have a shortened comment deadline for four items that were exposed: 1) *INT 23-02: Third Quarter 2023 Corporate Alternative Minimum Tax*; 2) *INT 23-03: Corporate Alternative Minimum Tax Guidance*; 3) agenda item 2022-11: Collateral for Loans; and 4) agenda item 2023-11-EP.

4. <u>Discussed Comments on a Proposed P&P Manual Amendment to Update the Definition of an NAIC Designation</u>

Mears said the next agenda item is to continue the discussion on the comments received on the proposed amendment to update the definition of an NAIC designation. As mentioned during the Task Force's July 13 meeting, the amendment was referred to the Capital Adequacy (E) Task Force, the RBC Investment Risk and Evaluation (E) Working Group, and the Statutory Accounting Principles (E) Working Group requesting comments. Those groups did not have any comments. During the July 13 meeting, the Valuation of Securities (E) Task Force directed the SVO to work with industry on creating a brief, straightforward statement as to the objective of an NAIC designation and why it is different than a rating agency rating and make additional updates to further simplify the definition. The SVO was also asked to consider different ways it could communicate to state insurance regulators the issues encapsulated in the current Subscript S descriptions and examples.

Draft Pending Adoption

Marc Perlman (NAIC) said NAIC designations are explained and defined in both Parts One and Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). The SVO proposed consolidating the explanations and definitions into Part One, because an NAIC designation is a fundamental policy of the Task Force. The amendment tried to clarify the meaning of an NAIC designation, including a designation's use, purpose, and risks addressed. Given the comments received, additional refinements to the amendment are necessary, such as adding a summary of the overall regulatory objective of an NAIC designation. The SVO met with industry on July 28 to begin discussions on additional definition simplifications and clarifications that can be brought back to the Task Force for consideration at a future date. Perlman said there appears to be some unfortunate general confusion about the proposed definition amendment, as most of the text would be unchanged. Nothing in the update changes the scope of responsibility for the SVO. An NAIC designation should reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, as well as the probability of principal and interest payment default.

There were several references made in the comments to the work conducted by the Risk Subgroup of the Invested Assets (E) Working Group, the predecessor to the RBC Investment Risk and Evaluation (E) Working Group. The Subgroup identified eight different risk attributes of a fixed income investment: credit, deferral, event, liquidity, call, extension, currency, and leverage. The Subgroup noted, "the impact of deferral was already explicitly incorporated into rating agency credit ratings." Given that it is explicitly incorporated into ratings, any deferral of payment is a risk that should therefore be considered as part of credit risk in the definition of an NAIC designation. The other risk attributes mentioned—events, liquidity, call, extension, currency, and leverage—and another risk referenced in the comment letters, portfolio risk, are not part of the current designation definition or contemplated as part of the proposed amended definition.

Perlman explained that a long-standing core objective of the Task Force and its work product, the NAIC designation, which is relied upon for many regulatory functions in the NAIC's Financial Regulation Standards, is to "assess the financial ability of an insurer to pay claims, meaning the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption . . . may result in the insurer not being paid in accordance with the regulatory assumption." This existing regulatory assumption that an insurer should be repaid in a timely, periodic manner is a core characteristic of an NAIC designation and credit risk, and it should be incorporated into the definition. Likewise, the statement that NAIC designations are, "standards identified in the NAIC Policy Statement and Financial Regulation Standards (SFRS) that have been incorporated into state law by States as participants in the Accreditation Programs administered by the Financial Regulation Standards and Accreditation (F) Committee," is a factual statement in the current definition that must remain in the updated definition. Commenters suggested that loss given default (LGD) should also be considered when assigning an NAIC designation. Perlman said the SVO agrees, and including LGD would be a similar consideration to including tail risk in that it is appropriate for certain asset classes, structures, or rating levels. Consideration of LGD and tail risk could be used to adjust an NAIC designation up or down, as appropriate. Perlman said if the Task Force agrees, the SVO can include these considerations in the definition.

Perlman said inclusion of separate instructions related to the assignment of the NAIC Designation Subscript S and its related illustrations also caused unintended confusion. The SVO would be happy to work on creating another means to broadly communicate privately to state insurance regulators that an investment may have unusual risk characteristics. It could take time to implement technology enhancements to deactivate Subscript S and create a new communications channel, such as specialized Jumpstart reports to share with the affected state insurance regulators through NAIC systems. However, Perlman explained that the SVO would be able to continue to communicate any issues or concerns it sees to state insurance regulators

Draft Pending Adoption

through things such as regulator-only educational meetings, informal calls, or new proposals to the Task Force, as needed.

Three comment letters were received: 1) a joint letter from the American Council of Life Insurers (ACLI), the Private Placement Investors Association (PPiA), North American Securities Valuation Association (NASVA), and Structured Finance Association (SFA) that included additional NAIC proceedings from 2008 of the Risk Subgroup of the Invested Asset (E) Working Group; 2) a letter from Athene; and 3) a letter from Anderson Insights LLC. The SVO plans to work on making these updates and bringing a minimally revised version of this amendment back to the Task Force for consideration.

Michael Reis (Northwestern Mutual), representing the ACLI, the PPiA, the NASVA, and the SFA, discussed some of the broad parameters of what may happen with the amendment. He said LGD should be part of the NAIC designation, but there was still confusion about whether tail risk should be in the definition. He said the members of the groups he is representing had varying opinions and need to fully vet it. He asked regarding Subscript S whether there would be a broad statement of what nonpayment risk is within the NAIC designation definition. Charles Therriault (NAIC) said Reis is correct. The concept would remain within the definition, but the separate reporting would be eliminated. Reis said Perlman mentioned a lot. He said the devil is in the details, and he needs to answer to his trade groups' constituents.

Sasha Kamper (Apollo and PPiA) said the PPiA has worked with the ACLI, others in the trade groups, and the SVO on the exposures. She explained that when industry drafted its responses regarding tail risk, the PPiA did not understand how tail risk would be used. In subsequent discussions, she said she understands that the concept of tail risk within a designation definition is to be a principles-based approach. She said she agrees that it is something to look at and figure out the details of how it is used later. She cautioned that if tail risk is included, it is important to be careful that various asset classes are treated fairly and tail risk is applied in a consistent way across asset classes. As she socializes the amendment with her constituents, she will probably have more to say both on tail risk and LGD. She said she is appreciative that it might be appropriate to look at LGD in certain situations.

Mears, with the permission of the Task Force, directed the SVO to: 1) continue to work with industry on the proposed amendment and draft language regarding the consistent treatment among asset classes; 2) include a brief summary of the overall regulatory objective or meaning, which would reflect the likelihood of the timely and full payment of principal and scheduled periodic interest, noting that the risk of payment deferrals will be included; 3) maintain the existing references to the NAIC's financial regulation standards; 4) include consideration of tail risk and LGD when appropriate for the asset class, structure, and rating levels; and 5) within its responsibilities to the Task Force, communicate with the Task Force as it finds different investment characteristics or other areas it believes the Task Force should know and potentially take action on. The SVO may also develop a means to communicate that information privately through internal systems that would not be public documents like Schedule D, and that process may take some time.

Chris Anderson (Anderson Insights LLC) said the topic calls for a very clear, concise definition in simple language that everybody can understand of what is in and what is out of a designation. He stressed that coordination between the other NAIC entities is paramount. As an example, he said if one looks at how RBC C1 and R1 factors were computed, both the frequency of probability of default and the severity were considered. LGD may or may not be in the RBC factors to the extent that it is appropriate. Chris Anderson said it is a matter that should be considered by the other NAIC entities as well, and having a clear and concise definition to share with them could be very beneficial.

5. <u>Discussed Comments on a Proposed P&P Manual Amendment Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the FE Process</u>

Draft Pending Adoption

Mears said the next agenda item is to discuss the comments received on a proposed amendment authorizing the procedures for SVO discretion over NAIC designations assigned through the filing exemption (FE) process. The topic was introduced during the May 15 meeting, and it stems from the Financial Condition (E) Committee's charge to the Task Force to: "Establish criteria to permit staff discretion over the assignment of NAIC Designations for securities subject to the FE process (the use of credit rating provider [CRP] ratings to determine an NAIC Designation) to ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives." Mears reminded various interested parties of the evolution of the topic. Several years back, the process began of receiving private letter rating rationales to get more transparency into the growing use of private ratings. At that time, there was discussion of the possibility of implementing discretion over those ratings to adjust the designation, should it be warranted, with the expectation that the rating change would be instantaneous and automatic. State insurance regulators at that time decided against that route, acknowledging insurer concerns of feeling whipsawed from waking up one day to a new designation it would need to utilize. Instead, the Task Force provided guidance to the SVO to bring thematic issues back to the Task Force to address, so the Task Force could look at the FE status of those asset classes. Mears said this approach worked well for a while. For example, principal protected securities (PPS) were removed from the FE process. However, the Task Force came across roadblocks as it observed more opaque structures. For example, earlier this year the Task Force deferred action on the proposed amendment related to removing structured equity and funds from FE following criticism from industry that the proposal was too broad. SVO staff recognized some issues with specific securities, and the common feature was the use of what was called structured equity and funds, or a feeder fund. However, there would have been several assets that would have been in scope that were not problematic. It was difficult to provide a scope that would be complete but also efficient in the number of assets that it captured. Industry asked if only the specific problematic securities could be addressed without removing whole swaths of assets from the FE process.

The Task Force was responsive to the industry request and directed SVO staff to draft the current proposal, which is meant to be limited in scope and target specific material risk assessment differences. Mears said the proposal was meant to have a distinct challenge process to provide insurers ample notice, as well as due process, by which an insurer can appeal any potential change well before an FE-produced NAIC designation is affected. The amendment would also address the charge assigned to the Task Force by the Financial Condition (E) Committee. It is incredibly important to note that designations ultimately fall under the purview of state insurance regulators. While the definition is still being worked on, it is necessary to clearly highlight this authority of state insurance regulators and reiterate that designations are solely for use within the insurance regulatory framework, and they are not ratings themselves. The FE process is just that; i.e., exemption from filing that would otherwise be required to be filed with the SVO to receive a designation.

Mears noted that rating agencies, or CRPs, provide an invaluable service, and the NAIC benefits by being able to utilize these ratings in the designation process, when appropriate. Given the number of securities and efficiencies gained by the NAIC in using rating agency ratings to assign NAIC designations, there is no intention of displacing or competing with them. However, because of how the NAIC uses CRP ratings in its processes, this is not an unconditional usage. There is a need and desire to build out a more robust framework for utilizing CRP ratings in the process, and that remains underway. However, Mears explained that even if this is implemented, there could still be instances where a rating is not aligned with NAIC expectations for a designation. The misalignment may even be unrelated to the CRP or methodology. A structure could theoretically have a rating that is fully appropriate outside the insurance regulatory system, but based on whatever policies or procedures the NAIC has in place at that time, the NAIC may need to make an adjustment within its framework.

Draft Pending Adoption

In exposing this proposal, Mears explained that the Task Force and the SVO recognize that the proposed process is not the final version, and she asked for comments to be as constructive as possible. She thanked the comment letter writers, as many of the letters provided constructive comments. She said there were many good suggestions made by interested parties in the comment letters, and the Task Force and the SVO will be working through many of those suggestions for a modified proposal. Mears commented on some broad themes. First, there is no intent to displace or compete with CRPs. The process was written to be focused on particular assets rather than to subject a broad asset class to removal from FE. The FE status of most assets would be unchallenged. Mears clarified that insurers may continue to use whatever nationally recognized statistical rating organization (NRSRO) opinions they deem appropriate for their decision-making process. The proposal is specific to how NAIC state insurance regulators, as consumers of rating agency ratings for regulatory purposes, choose to use them in the regulatory process. Mears said the SVO will continue to provide a centralized source of investing expertise to support any state insurance regulators in this responsibility. She said while the involvement of an independent, third party to validate individual rating challenges would be costly, inefficient, and not aligned with the NAIC regulatory process, the Task Force should consider how to conduct additional oversight of the SVO in conjunction with the proposal, and that may involve engaging an independent third party to perform a periodic assessment of the reasonability of the SVO's analysis, its operational processes, and supporting systems. She said other themes in the comment letters included additional transparency during the challenge process, more regulatory oversight, and possibly a look-back or review of the process after implementation. She noted that the Task Force and the SVO will look at each of the suggestions and consider carefully how it can enhance the process, whether as suggested or with a minor adjustment.

Therriault said the SVO has reported to the Task Force on several occasions that it has observed growing and often material discrepancies between the ratings provided by competing NRSROs for the same security. The SVO also reviewed with the Task Force specific examples of the significant differences it has observed with some CRP ratings versus the security's issuance spread relative to similarly rated investments, risk assessment differences when applying other CRP methodologies, and comparing the investment to other CRP rated peers. Therriault explained that the examples were all privately issued and privately rated securities, meaning the SVO cannot publicly discuss the specifics of the security, the rating, the rating methodology, or the rating agency. Other than a generic summary of the issue, the SVO is precluded from being transparent about the issues because it must maintain the confidentiality required by non-public investments. Commenters mentioned transparency repeatedly. Much of what the SVO sees are privately issued and privately rated transactions. By their very nature, there is no transparency of these privately issued investments, and the SVO is restricted from sharing all but the most generic information about them. Prior to 2018, when private letter rated securities first needed to be reported to state insurance regulators through the SVO, no one knew anything about these investments or that they were being privately rated. Additional transparency into these securities was only revealed to the Task Force through the SVO beginning in 2022, when the rationale reports first needed to be submitted. The rating exceptions identified by the SVO to the Task Force only came about because of the requirement for increased regulatory transparency into these non-public transactions. Otherwise, the Task Force would continue to be completely blind to these issues. Therriault cautioned that the SVO cannot be put into a position of being required to disclose highly confidential private information to anyone other than an NAIC state insurance regulator who has a regulatory need for this information or if compelled by a court order. Regarding SVO methodology, as the SVO stated on numerous occasions, it frequently uses large NRSRO methodologies, primarily Moody's Investors Service (Moody's) and Standard & Poor's (S&P), when it reviews securities because the SVO general finds those methodologies to be clear, reasonable, and widely accepted across financial markets. Additionally, Moody's methodology served as the basis for the current RBC factors. However, the SVO could provide a highly generic summary without breaching confidentiality, provided it does not identify the security or issuer directly or indirectly, or the rating agency, if privately rated. An example of such a generic summary for a recent filing would be something like the following:

Draft Pending Adoption

> An insurer submitted a security to the SVO for review in which the insurer applied a Moody's methodology, one of the primary CRP methodologies the SVO often uses to review securities. The insurer's application of the methodology scored the entity's brand strength at the ‘AAA’ level, while the top brands in this sector that were rated publicly by Moody's only received a ‘Baa’ for this factor, a substantial seven notches lower. Other financial measures used by the insurer when applying this methodology made adjustments to debt that lowered the amount of debt outstanding, adjustments that improved the financial ratios and are not used in this methodology. The resulting SVO credit assessment differed from the insurer's assessment by three notches.

Therriault said publishing information about the transaction in any greater detail, including the issuer sector and specific methodology, would probably violate the confidentiality the SVO must maintain. The SVO would be willing to discuss privately with those insurers that had invested in the security. If industry finds that level of transparency useful, the SVO could look into publishing that type of information on the SVO web page. As just demonstrated, there can still be significant differences of interpretation when applying a methodology, even from a large rating agency.

Perlman said many of the comment letters point to a rating agency’s NRSRO status as a sort of seal of approval by the U.S. Securities and Exchange Commission (SEC), from which the NAIC should derive comfort as to the quality and reliability of an NRSRO’s ratings. He said it has been previously explained at Task Force meetings, but which bears repeating, that the purpose of the Credit Rating Agency Reform Act of 2006 (CRARA), pursuant to which the SEC grants NRSRO status, was to foster accountability, transparency, and competition in the credit ratings industry. The CRARA requires NRSROs to make public certain information to help users of ratings, like the NAIC, assess the NRSRO’s credibility and compare the NRSRO with other NRSROs. As with other federal approaches to securities regulation, the focus of NRSRO regulation is on disclosure. While the SEC closely monitors the internal controls of NRSROs, governing conflicts of interest and adherence to their own methodologies, under the CRARA, the SEC is prohibited from regulating the substance of credit ratings or the procedures or methodologies by which an NRSRO determines credit ratings. The SEC does not and cannot validate or approve any rating agency methodology. The SEC does not and cannot endorse or certify that there is any equivalency between any NRSRO ratings. Ratings are opinions of risk, and the CRARA leaves it up to the consumers of ratings, like the NAIC, to decide how they will use those rating opinions for their own use, including not using them at all.

Perlman explains that under the current proposal, the NAIC, as a user of ratings, would neither be regulating nor publicly challenging any of the NAIC’s methodologies. Additionally, several comment letters proposed oversight processes for the SVO, which appeared to be excessive and intentionally burdensome, given that no such process exists for NRSRO ratings. If a ratings consumer disagrees with an NRSRO rating or the reasonableness of some aspect of its methodology, the consumer cannot appeal to the SEC or an independent third party to overrule or modify the methodology or rating. The consumer can instead use or rely on NRSROs with methodologies that meet its needs. As mentioned in prior meetings and by some of the commenters, there is no provision in any NAIC guidance, such as the P&P Manual, that permits any state insurance regulator or the SVO to overrule or disallow a CRP rating. Perlman said that is precisely the purpose of the amendment, to create a means by which the NAIC can decide, through the efforts and experience of the SVO, how it will use those rating opinions or not use them at all when regulatorily appropriate. The premise that CRP ratings should be untouchable, unquestionable, and unchallenged by the NAIC was implied in many of the comment letters. However, such treatment is in direct contradiction to the policies of the Task Force and the mandate from the Financial Condition (E) Committee. It is also inconsistent with the objective of the CRARA of allowing the consumer of ratings to decide how and if they will use those rating opinions. The NAIC does not avail itself of that right.

Draft Pending Adoption

Therriault said it would be helpful to step through the proposed process envisioned by the amendment. Step one is the establishment of the materiality threshold required to flag a CRP rating as in a review. To limit the NAIC's use of this process to only that which would be considered truly material differences of opinion, the SVO would only be able to put a security or CRP rating on notice if it determines, based on the available information, that the CRP rating used in the FE process is three or more notches different than the SVO's assessment. The SVO proposed criteria that it has successfully used to identify such exceptions for the Task Force, which is the comparison to peers rated by other CRPs, the securities yield at issuance or current market yield compared to other securities at that NAIC Designation Category level, or the SVO applying methodologies from another CRP. The SVO frequently uses methodologies from very large NRSROs because it finds them to be clear, reasonable, and widely accepted across the financial markets. However, there can still be differences in the application of the methodologies, which can be discussed with a specific insurer.

Therriault said step two is a means to notify insurers that the SVO is looking at the FE-based designation. Nothing changes at that point; it is just a notification. It is anticipated that insurers will provide additional information to the SVO during this notification period to support why the CRP rating should be maintained. What information will be needed depends on the specific types of securities; there is not a standardized list. It is subject to the asset class that is being reviewed and the information available to the SVO. The proposal provides a sufficient notice period to allow an insurer to decide whether it wants to appeal and provide additional information before any action is taken. Insurers would have up to 120 days to appeal the SVO's assessment notification by introducing additional information and data, as necessary. The 120-day appeal period is similar and consistent with the existing appeal period for an SVO-assigned designation. If an insurer appeals, that review process could take an additional 90 days or longer. During the SVO review, applicable state insurance regulators would also have the opportunity to be consulted on the deliberation if they request. If, after the SVO review, it determines that the CRP rating should be excluded for that security, the insurer would have another 120 days to either submit the security for review by the SVO or acquire an alternate CRP rating, thereby permitting continuation of the FE eligibility.

Therriault explained that it may take nearly a year or more from the initial notification until any action is taken on an investment, providing insurers ample time to respond and participate. There will not be any abrupt changes. The discretion process could take two to three years to implement and could be designed to permit multiple insurers that own the security, as reflected in the statutory schedules, to join in the appeal. The connection to the statutory schedules is necessary to allow SVO staff to know which insurers are permitted to have access to the confidential information related to the security and who they can share their observations with given that these may likely be privately rated securities. It would be up to the insurers to decide whether they wish to participate.

Therriault said the SVO assessments of investment risk have been compared to insurers' own investments' assessment of risk, and they have been found to be reasonable. He noted the Society of Actuaries (SOA) study titled, "2003 to 2015 Credit Loss Experience Study: Private Placement bonds," for the topic of "Rating Consistencies: The main quality rating used in the study, the internal rating supplied by the contributors, [i.e. the insurance companies] for each CUSIP for all years, was found to be consistent across two dimensions. Based on comparisons of commonly held CUSIPS, [internal] ratings were very consistent between contributors. They were also reasonably consistent in comparison to NAIC ratings [i.e. designations]."

Therriault then listed actionable recommendations from interested parties that should be incorporated into the proposed amendment:

1. The SVO publishes a generic summary of the reason for its action; i.e., that it maintain the confidentiality of the issuer, rating agency, and rating.

Draft Pending Adoption

2. Include in the SVO's annual report to the Task Force at the Spring National Meeting information on several ratings challenged, the outcome of the challenges, and the average number of notches of the change.
3. Separately, submit a request to the Executive (EX) Committee authorizing the NAIC to engage an independent third party to perform a periodic review and assessment of the reasonability of the analysis, its operational processes, and supporting systems, and provide the Committee with a private and public assessment and recommendations. It would be up to the Committee as to how frequently such a report should be submitted.

Therriault said credit analysis is both an art and a science; differences of professional opinion are unavoidable. The SVO has proposed materiality thresholds to ensure that it is only focusing on material differences of opinion. The SVO agrees that CRPs have areas of strength and expertise, but they also recognize that there are eight different sources of credit rating opinions today, and those opinions can be significantly divergent. NAIC Designations are specifically intended for state insurance regulators, and they do not have a choice as to the opinions used in their regulatory framework. The proposal gives the state insurance regulators, through the SVO, over which the Task Force has oversight, the ability to align opinions to their risk tolerance. The checks and balances in the proposal, with the modifications that were mentioned, will provide the Task Force and industry comfort that the investment risk assessments are reasonable. The SVO recommends that the Task Force continue its overall assessment of CRP ratings, a project it initiated last year.

Walker said she understood the process, and the direction to SVO staff to draft the process, was about strengthening Task Force reliance upon the CRP ratings, but also allowing a relief valve whenever staff or state insurance regulators notice significant outliers in what is being produced through the process. Therefore, Mears' opening comments, that this process is not intended to replace CRPs aligns with Texas's view. Garcia said it should create certainty for industry going forward that new and emerging asset classes are developed; this process can be used as opposed to creating uncertainty with an insurer not wanting to get into the new asset classes because it does not know whether the new asset class will be FE or not. She said the process is painful at this at this time, but it is a great base and foundation to build on going forward, as there is more innovation in the investment markets, and it will prevent retreading the same ground repeatedly. She said she was excited to hear what Therriault explained about the process. She said it is not perfect now, but we will take all the feedback and work through an iterative process to get something that everybody knows, understands, and is comfortable with.

Cotrone asked Therriault to confirm that no action will be taken on an NAIC Designation until after the insurer is notified and can go through the full appeal process. Therriault confirmed and explained that first there would be notification that the SVO is looking at something that it thinks is off the mark. The insurer could provide information to discuss that with the SVO. At that point, the SVO will know, if it is a private rating, that it has the ability to breach that confidentiality shield. Then, the SVO can discuss that with the insurer and decide if it wants to appeal. When the SVO decides that it should be removed from FE, there is still the option to go to an alternate rating agency to get a different answer or file the security with the SVO for review. Therriault said the process could take nearly a year before security moves from FE to out of FE or to another CRP.

Mears said several comment letters were received on the proposal, and she wants to ensure that everyone has a chance to speak to their comments. She listed the comment letters: a joint letter from the ACLI, the PPiA, the NASVA, the SFA, the Mortgage Bankers Association (MBA), and the Commercial Real Estate Financial Council (CREFC); the Lease-Backed Securities Working Group; Chris Anderson; Michelle Delaney; the National Association of Mutual Insurance Companies (NAMIC); the Bank of Montreal (BMO); Genworth;

Draft Pending Adoption

Teachers Insurance and Annuity Association of America (TIAA) Financial Services; Piper Sandler Companies; Group 1001; and Marty Carus (Martin Carus Consulting LLC).

Reis said he would briefly summarize the letter from the ACLI and the joint trades with the most basic concern being related to transparency. The first issue is that the designation challenge rests with the SVO and one state insurance regulator, yet other insurers may hold that same security, perhaps in other states, potentially resulting in extraterritorial regulatory approval. Also, the SVO would be making its objection or determination of a material discrepancy based on incomplete information. Then, on appeal, the insurer would be allowed to provide additional information. Reis said that seems more like an initial filing rather than an appeal. He said this was concerning to many members of his constituency. He said his constituency also thought there should be additional checks and balances on "appeals." He said there should maybe be a third party so the SVO is not judge, jury, and executioner, a term discussed by his constituents. He explained that there should be transparency to all partners affected and transparency about what is affected, whether it is just the security; a whole asset class; a subset of an asset class; something broader than the asset class, such as a methodology; or one or more rating agencies. There should be transparency as to the rationale and what was inappropriate with the rating rationale. Reis explained that the reason for the transparency request is if there is a problem with a security and that rating gets changed, industry will be left wondering whether the problem is with the whole asset class or a subset of that asset class. Industry is concerned that the private market, of which industry holds substantial assets, could freeze. Reis said there have been instances where certain segments of that market have been frozen due to challenged ratings or similar things. He said industry is ready to assist in addressing specific problems that are identified, but there are problems with transparency. He said Therriault had mentioned that the SVO uses large rating agency methodologies, but industry has heard that those rating methodologies can be misapplied. He explained that a rating methodology applies to apple pie, but it might inappropriately be applied to pumpkin pie. He said there are specific instances where that has happened, and he said he could share the details later. He then addressed materiality. He said it is predicated on a material discrepancy in ratings, and the SVO would be making its objection to a rating with incomplete information. He then addressed the appeal, which he said is not really an appeal but rather a security filing so the SVO has complete information. He reiterated his belief that there is not a real appeals process where there is recourse other than to the SVO.

Mears asked Reis to describe his concern about the providing of incomplete information. She asked if it is that he would want to see that happen in a different order. She explained that by its nature, the SVO would not receive complete information. She asked Reis what he believes the process should be.

Reis said he would answer in two ways. One, the process as outlined would be that the SVO thinks the rating is X, which is three notches higher or lower than the rating that is assigned; therefore, your insurer can file an appeal. Otherwise, the SVO rating stands. Reis explained that the SVO assessment was made with incomplete information, which seems like a backwards approach and is not really an appeal. He said if there were a process, and he clarified that his group has not talked about what the solution is, and the SVO would like to get additional information, it could be shared. He said that is a different process; i.e., the SVO saying it has the answer based on incomplete information.

Therriault said the process envisioned was for the SVO to give notice of what it is thinking and, at that point, to ask industry, through the notification, for additional information. If industry believes the SVO is off the mark, that would be the means by which the SVO would get the information Reis described. Therriault explained that if the SVO does not have a means to communicate to all parties that may be invested in the security in an efficient way, the SVO will not know who to reach out to, how it is going to get the information, and how it is going to be transmitted through NAIC systems. He explained that even if the SVO received the information, it would not be an automatic change in the designation. The only thing it would do is remove it from the population of FE, which then means it is a status change, then the insurer has other

Draft Pending Adoption

options to avail itself, such as another CRP rating if they want to request an alternate review, or a traditional full SVO filing, if the SVO had not received sufficient information already.

Reis said much of the process outlined by Therriault presumes that the rating is wrong based on the SVO assessment, which is based on incomplete information.

Therriault said that is correct, but he referred to the comments made by Perlman; i.e., there is no challenge process for a rating that exists anywhere. One cannot tell the SEC that rating agency X's rating is incorrect and ask the SEC to overrule it or make the rating agency change the answer. Therriault explained that this is a way for the state insurance regulators to avail themselves of a professional group that supports them to provide that function.

Mears said maybe there is another notification process where additional information is needed or something along those lines. She said we can take back that concern and think through what the enhancements would be.

Reis said there is a strong conceptual concern, but there are broad implications. If there is a hundred X types of securities in the market, one of those securities gets picked, and that rating gets notched down three notches, it is going to spread like wildfire through industry that the SVO has a problem with X security. Reis explained that industry would not know what the problem with the security is, and questions would arise, such as whether the whole population of 100 securities is at risk; whether it is a sub-population of those 100 securities that has certain characteristics; or whether it is the rating agency methodology that may rate 40 of those, but the other 60 are not at risk. He explained that if there is fear in the market, that whole population of securities could freeze up because certainty of capital is lacking.

Kamper talked regarding incomplete information. She said what industry envisioned that the information that the SVO would have on the security is the private ratings letter and whatever information is available on Schedule D. The SVO would not have had access to the financials, a private placement memorandum, the legal docs, etc. When this proposal is put into action and those securities would be flagged, that is then when the SVO would come and talk to the insurer; the insurer would provide that information; the SVO would do a more thorough due diligence; and there would be a discussion most likely between the insurers that own the security, the CRP that rated the security, and the SVO. Kamper said her constituents view that dialog as similar to an initial filing, as if the SVO would have designated and assigned a designation absent a CRP rating. She said one of the concerns is that in the rare chance that after going through that process, the insurer and the SVO cannot come to a meeting of the minds and the insurer still feels strongly that there are fundamental reasons why the rating is appropriate and there is information the insurer wants to present, there needs to be a second place to have that dialog again. She said it is important that in the rare situations—most likely a methodology challenge—where there is something fundamental about the asset class that would affect a broad number of securities, not just any individual security, insurers would like to be able to bring its concern to the Task Force, or some subset thereof with expertise in these issues to bring the concern to. She said she would not envision that happening frequently, but she believes it is important to have an additional place of appeal because her constituents view the 120 days in the exposure as more like an initial filing. With respect to confidentiality language, she said she understands it is a big challenge, but she knows the SVO has provided some examples in the past where it has masked which rating agency assigned the rating and just speak in terms of NAIC equivalent ratings, and it has masked the name of the issuer and watered down the information enough that people can understand what the nature of the underlying transaction is, but it does not necessarily give away who the rating agency is or who the issuer on the deal was. She said the SVO has been able to overcome that challenge in the past and share with the small group, and that is the type of disclosure that industry is looking for here, mainly to avoid what Reis was referring to, meaning the situation where if many insurers have similar securities and the SVO is concerned

Draft Pending Adoption

about a very specific issue that affects the security or a certain methodology, that it does not cause unnecessary disruption to a broader range of securities than just that the SVO is concerned about and wants to challenge and talk about. She said from her constituents' perspective, transparency is key and would appreciate to the extent that the SVO can accommodate, as well as adequate due process, meaning a place to have concerns heard, be able to have a good dialog, and hopefully get to a decision that makes sense for everyone.

John Garrison (Lease-Backed Securities Working Group) said the Lease-Backed Securities Working Group believes the investment community and the state insurance regulators share the same desire for efficient, well-regulated markets that benefit everyone. It goes without saying that markets hate uncertainty. Any policy that allows the NAIC to question and potentially overturn individual CRP ratings after a bond has been purchased by the investor will inevitably create uncertainty in the markets and have a harmful effect on insurance companies, and they will be the only market participants subject to this added uncertainty. Garrison said even the mere discussion of the issue has already started to freeze markets for many securities where insurance investors have simply said they are not going to consider it because there is too much uncertainty involved with making that step. That being the case, the Task Force should strive, wherever possible, to minimize the negative impacts of the policy while preserving the ability to effectively regulate. This could be done, Garrison suggests, by limiting the scrutiny to only those companies where state insurance regulators feel the problem rises to a level where it could have a material impact on an individual company's capital ratios, or by making it clear that only certain classes of securities would be subject to this additional level of scrutiny. Responding to the comments of Reis and Kamper regarding incomplete information, Garrison said the fear is that the SVO will always be operating to some extent on incomplete information. To the extent that NRSROs can talk to management, they can do many things that the SVO is unable to do and that the Lease-Backed Securities Working Group believes the NRSROs will always have a bigger, fuller picture of a credit. Garrison said any analysis by the Investment Analysis Office (IAO) that questions the work of an approved CRP should be justified to the investor in the form of a full ratings rationale report equivalent to the fulsome reports published by the NRSROs and already provided to the SVO, which provide a detailed explanation of the analysis by the CRP, the credit issues, the legal issues, and any mitigants. Regarding the phrase of blind reliance on ratings, he said he understands that the state insurance regulators want to preserve the ability to question ratings in some instances, but it is hardly blind. The report prepared by the SVO or the IAO should highlight specific errors and omissions in the CRP analysis and the specific reasons the IAO reached a different conclusion. Garrison said the sample paragraph Therriault read as an example is insufficient. He said the SVO cannot just say it looked at all the same information, but it just came out with a different opinion. He also agreed that many of the proposed steps put forward by the Financial Condition (E) Committee framework to modernize the SVO, including the establishment of a broad investment working group under the Committee to act as an adviser and hopefully to harmonize the various different investment-related projects that are underway, including this one, and also with the hiring of an external consultant to advise the Working Group and provide guidance on any policy-related issues. He said the Lease-Backed Securities Working Group believes that these recommendations, as well as the other steps contained in the Committee framework, should be brought into this discussion before any specific policies are implemented by the Task Force.

Chris Anderson said his comments are in the context of the Bond Project, which had just been adopted and should give state insurance regulators confidence that some of the problems that existed or may have existed will be dealt with. Turning to his letter, he said his conclusion was that it would be terrific to have a fresh look at how state insurance regulators can benefit from the resources of the NAIC with respect to their responsibilities to assess the credit quality of the assets of insurers. He referenced a study 25 years ago from an outside consultant and another more recent one saying those kinds of recommendations are appropriate now because the discretion proposal is a sweeping change in the responsibility of the SVO. He said years ago, the SVO was responsible for coming up with securities valuations, and now it comes up with some

Draft Pending Adoption

measure of risk, which in his opinion is essentially credit risk. He said it may well be time to look more fundamentally at how you can be served the best, and hopefully that can be addressed.

Chris Anderson said with respect to this proposal, there is tremendous new power that the SVO will have, and the idea that a security or a class of securities can be put under a cloud for even a brief period of time is market making and market moving and should not be ignored. The notion that it can be done for a year is inconceivable to market participants who are looking at securities on a moment-to-moment basis. The idea that one insurer may have information that other insurers may lack about the status of security and the reasons it is under a cloud can influence the fairness of trading. It could even prohibit the insurer from selling a security because of fear of trading on material nonpublic information. Chris Anderson said a proposal this sweeping needs to be accompanied by better governance, which is the theme of his letter. Regarding better governance, he said he outlined specific steps state insurance regulators can take to oversee the processes. The most fundamental step is something that existed before namely one, but probably more than one, working groups specifically dedicated to these questions. He clarified that a working group is a group that would actually do work. He said there cannot be 26 task force members all responsible for what goes on at the SVO; although, ultimately, they are. However, the Task Force needs arms and legs; i.e., people who are focused on it. Chris Anderson said in his letter that he outlined specific steps that can be taken for the Task Force to have visibility as to what goes on in the process.

The model is essentially what the SEC did when it wanted to have visibility and transparency to the work of rating agencies. Chris Anderson said it has been called burdensome, and he said it would take a significant period of time. He said he understands that that it would be a burden for the SVO because it has never done many of these things. He explained that the SVO has never produced the kinds of documents outlined in his letter, not the least of which is a ratings transition matrix, in other words the SVO's report card. With those documents, the Task Force will be able to assess the work that is being done by the IAO. Chris Anderson asserted that the idea that, as in the proposal, once a year the Task Force may request information about what the IAO has done in this regard is indicative of the notion that the proposal contemplates no disclosure. He said he is advocating for a group that digs into the operations of the SVO and demands accountability.

Chris Anderson said a second group that would be useful is something that existed many years ago, called the Rating Agency Working Group. The Working Group worked closely with the SEC. Chris Anderson said a web search will show interaction between the SEC and the NAIC concerning what kinds of information the NAIC would want. There are many things the Task Force could do, as state insurance regulators, if it had a working group to review the capabilities and performance of the NRSROs. Chris Anderson said Form NRSRO has incredible detail about the performance of rating agencies, and it is a model for the IAO. The SEC reports annually on infractions or performance of rating agencies in a generic form, but there are several things the Task Force can do if it wants to focus on and improve state insurance regulator visibility on the performance of the NRSROs.
Chris Anderson is afraid that aside from the clouds it will cast over various securities and classes of securities, there are problems with this proposal. He asserted that the notion that one can come up with a three notch difference by using peer review, yield analysis, market yield, and other tools is flawed. He said by peer review specifically, the example of 43 securities was an apples-to-oranges comparison, and that was referred to an ad hoc group. He said he understands that that approach was never validated. Furthermore, if this is not intended to be used to an apples-to-apples review, in other words, two rating agencies rating the same asset, then for private placements, the SVO has noted that only 15% of private placements are rated by more than one rating agency. That means 85% of the private placements the SVO would be looking at would not be able to do an apples-to-apples review. Chris Anderson summarized that the proposal needs a lot of work, and hopefully there will be an opportunity for outside consultants to look at it.

Draft Pending Adoption

Mears summarized Delany's comments stating that Delany noted that the NRSROs are regulated by the SEC and described the application process. Delany goes on to note that the NRSROs focus on collateral, along with the credit worthiness of the borrower. She highlights that she relies upon NRSROs for making credit decisions in a former role at a large regional bank. She suggests that the SVO should also be subject to an independent review in its provision of designations, as well as highlighting the suggestion that a third-party provider could assist with the request for proposal (RFP) for the review of the NRSROs.

Colleen Scheele (NAMIC) said NAMIC agrees with all other interested parties as it relates to transparency, and it looks forward to continuing the conversation with state insurance regulators and NAIC staff.

Mears summarized BMO's comments stating that BMO provided some considerations based on its observations. BMO noted that the rating agencies have been approved as NRSROs by the SEC due to comfort with their rating methodology and track record over time. They would like rating certainty, as there could be impacts to deal flow. They also note that adoption of this proposal could set a precedent for future negative amendments, increasing the riskiness of investing in private placements.

Michael Shepherd (Genworth) said he believes Genworth's concerns had been addressed by the ACLI and others.

Mears summarized the TIAA's comments stating that the TIAA has specific concerns with Sections 81 and 170 of the proposal. The TIAA does not believe the proposal demonstrates a requirement for the SVO to provide its own analysis or explanation as to why the CRP provided rating was challenged. The TIAA also makes a reference to an assumption that we have gone through this process before with 43 securities, and the Task Force did not approve a method to override the ratings at that time. The TIAA recommends that a clear methodology be outlined, and it noted that the SEC closely regulates all the NRSROs.

Mears summarized Piper Sandler's comments stating that Sandler indicated that the current NAIC proposals have already caused major market disruption as word of the pending proposals permeated all levels of the insurance industry. They said some number of insurance companies have instituted a moratorium on certain rated transactions in the markets, and prior to buying a particular transaction, insurance companies should know what the NAIC Designation will be in order to monitor the regulatory capital charges. They talk about some of the rating agencies that are in the market, and they have seen some potential drop off in the total number of deals and respective transaction sizes. An increasing number of insurance company investors learned of the proposed NAIC/SVO's intent to provide the credit risk designations to FE securities, and they noted that the market has come to a virtual halt denying many strong and viable companies the ability to raise capital. They give some statistics regarding some of the ratings that have been in place. They note that the NAIC/SVO does not have the required resources, analytical capability, or regulatory status; i.e., not an SEC-regulated NRSRO to implement unexpectedly high credit risk designations. They say insurance clients always carry out intense due diligence and all corporate credits that have come to the market. They note that this could impede the ability of smaller corporations to raise capital and provide strong value added investments for the insurance industry.

Bob Turner (Group 1001) said Group 1001's letter echoed many of the other themes from the other letters. He said he wants to discuss the impact of the Bond Project. He said many of the examples brought forth to industry in previous meetings would be addressed by the Bond Project and the new definition. Consideration should be given not just in the scope of securities that could be affected, but the timing of having to implement the Bond Project at the same time. The total scope of this proposal seems to be unlimited and could affect any number of securities, so there should be some consideration given to certain attributes of securities. Previously, there was the bespoke security letter that talked about red flags. Likewise, there should be attributes to some securities where insurers can have confidence that there will not be any

Draft Pending Adoption

expectation of a challenge based on certain attributes of those assets within the marketplace. Turner also said he echoed what other people said about transparency, and more insight into specific concerns would allow industry to come to the table with some alternative solutions, as well as the SVO's methodologies so people can better understand any appeal process and what the SVO's rating methodology would look like.

Mears summarized Carus's comments stating that he notes his experience as a state insurance regulator for 43 years and participation in NAIC activities during that tenure. He is now a consultant, but he offers his comments as a consumer policyholder of various insurance products and investor in insurance companies and as a taxpayer. He notes this proposal, like most NAIC proposals, does not define the associated costs that are ultimately borne by policyholders or investors. The proposal also does not estimate quantification of the benefits associated with it. As a taxpayer, Carus finds this problematic. He views this proposal as an attempt to overturn the existing FE process. He notes that no major market participant has encountered a severe adverse market event in decades. He lists several questions, including why the proposal is being made at this time, why there is no materiality threshold, what specific conditions have arisen, whether the insurance industry has experienced a financial strength decline due to its investment operations outside of the normal cyclical economic conditions, whether there are examples of companies abusing the fee process to the extent that its RBC calculations were materially misstated, and whether the current solvency regulatory regime is good enough as it is. He then goes on to note concerns with the fact that the timing of the challenge would occur after the investment is made.

Steve Broadie (American Property Casualty Insurance Association—APCIA) said the APCIA did not file comments, but it wants to associate itself with comments made by the ACLI and the other trade associate associations that joined in that letter.

Mears said the next steps are for the Task Force to provide direction back to SVO staff. The direction is to work through the actionable comments in the comment letters and incorporate, as needed. Mears said she would look to Task Force members if there are any specific areas that should be highlighted and further discussed.

Crawford said from the Nebraska standpoint, as heard from several commenters, there is a need to look back at the appeal process and the process of bringing the concerns to an insurer. The ultimate authority needs to rest with the states, and there should be a solution where the authority lies with the states. It could be through a committee, because of the issue of when a company in one state of domicile affects multiple. Crawford mentioned overall transparency and heard the concerns that were brought before the Task Force. The Task Force needs to take those seriously and provide as much transparency as it can, understanding the legal implications of that.

Cotrone said Connecticut agreed with Nebraska's comments. He said there is a need to take into consideration interested parties' comments, such as how to improve the process. He said the comments have provided some very valuable insight.

Mears said most Task Force members would be in agreement that increasing transparency would be a priority. It can be looked into in accordance with the confidentiality issues. There should be an annual report on the number of ratings challenges, outcome of challenges, average number of notches, and possibly some interim reporting, particularly at the initial onset of such a process. Mears said the Task Force should request the engagement of an independent third party to periodically review the operations, analysis, and systems of the IAO. It would require Executive (EX) Committee authorization, but there is the Financial Condition (E) Committee framework that contemplates the usage of such a resource for a purpose like this. Every suggestion that was made will be reviewed in good faith to determine whether it can be incorporated into the process. Mears asked Task Force members to read through the comments and think about this so

Draft Pending Adoption

further guidance can be provided to the SVO as this proposal is updated. She noted the related pending Financial Condition (E) Committee exposure stating that it is much broader than this Task Force proposal. As comments are received on the Committee proposal that may have implications for the Task Force initiative, that will need to be considered.

6. Heard a Staff Report on the Proposed CLO Modeling Methodology and the Ad Hoc Working Group

Eric Kolchinsky (NAIC) said the collateralized loan obligation (CLO) ad hoc group has continued to set the assumptions for CLO modeling. The assumptions for prepay and purchase pricing were recently finalized. The next step is to look at scenarios and probabilities. There will be a suggested set of scenarios, and based on those, the CLO ad hoc group will seek to set probabilities such that the risk of the underlying loan is approximately equal to the risk of the sum of the tranches. Kolchinsky said the next meeting of the CLO ad hoc group would be after Labor Day.

7. Received Final CRP Questions

Mears said the next agenda item is to note that the SVO received feedback on the initial list of questions to CRPs. She said the responses were private because some of them came from the CRPs themselves, and the Task Force was not going to publish those comments. The responses helped to create a final list of questions, which are published on the Task Force website. The submissions will be formalized to the CRPs, which starts the timeline of scheduling meetings with them as the responses are received over the coming months.

8. Discussed Other Matters

Mears had one additional matter. Fitch Ratings downgraded the U.S. government to AA+ from AAA. Along with S&P, that makes two rating agencies that no longer maintain an AAA rating on the U.S. Currently, the NAIC Designation of U.S. government obligations is fixed in the P&P Manual at NAIC 1.A. Therefore, any upgrades or downgrades do not change the NAIC Designation as they would with the FE process. If the NAIC Designations were governed by the FE process, U.S. government obligations would be at NAIC 1.B. Mears said the Task Force will need to talk about this issue. She said there is no recommendation, but she wants to ensure that the Task Force understands the implications and how that flows through the system, and if there is anything the Task Force needs to address, either within the Task Force or even with some of the groups the Task Force coordinates with, including the Statutory Accounting Principles (E) Working Group and the RBC Investment Risk and Evaluation (E) Working Group.

Having no further business, the Valuation of Securities (E) Task Force adjourned.

https://naiconline.sharepoint.com/teams/svovostaskforce/shared documents/meetings/2023/2023-11 fall nm/01-meeting minutes/2023-011.01 vostf_2023-08-14_summer_nm_minutes v5 (final).docx

The History of Filing Exemption and Reliance on Rating Agencies

2023 NAIC Fall National Meeting

Marc Perlman
SVO Managing Investment Counsel
December 2, 2023

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Agenda

- Chronology
  - The early years
  - The modern era
- Provisional Exemption
- Full Filing Exemption
- Since FE

Chronology - The early years

- **1907**
  - Concerns about discrepancies in insurer valuation practices
  - Following Panic of 1907, NY insurance department and NAIC Committee on Assets suggested uniform valuations.
- **1909**
  - NAIC Committee on the Valuation of Securities was established and charged with developing and maintaining a national uniform valuation procedure
  - Committee decided to become sole source of values and to hire expert (Marvyn Scudder, Esq.) to produce them

Chronology - The early years

- **1930s**
  - Recognizing that "value" fluctuates, often for reasons unrelated to creditworthiness of issuer, Committee sought objective benchmark for investment "quality" (i.e. "amply secured" - amortized, not "amply-secured" – mark-to-market)
  - Committee begins to acknowledge need for internal technical staff to make amortization determinations and produce uniform values for securities not eligible for amortization

Chronology - The early years

- **1941**
  - Credit ratings used as test of amortization eligibility:
    - Bonds rated in any of the first five grades by at least two rating agencies
- **1943**
  - Committee stopped using external consultants to produce values
  - Hired its own staff to produce valuations and amortization determinations
- **1945**
  - SVO established (Valuation of Securities Office)

Chronology - The early years

- **1949**
  - SVO tasked with developing standards and criteria for private placements
- **1951**
  - Current analytic standards *and critiques*:

    1. Credit ratings – *a rating agency's approach and objectives may differ from those employed by the technical staff of the Committee.*

    2. SVO unique methodology for private placements - *a lack of readily available and sufficient information concerning publicly traded bonds with which to compare the securities under review*

Chronology - The early years

- **1953 to 1989**
  - A corporate obligation was eligible for amortization if it was rated in one of the four highest grades (i.e. investment grade) by one of the recognized rating agencies
  - If it were not, it could still be amortized if it met certain financial ratios
  - Subject to further review and examination for any cases having predominant weakness or strength.

Chronology - The modern era

- **1989**
  - Where appropriate, SVO uses Zeta Services quantitative financial model and past financial statement data to determine a preliminary measure of the relative financial soundness of issue
  - Model result will not be sole determinant of NAIC Designation
    - SVO will review 5 years of historical financial data, if available, and any projected financial data
    - SVO will focus on security specific factors: covenants, structure, collateral, <u>ratings</u>
- **1990**
  - (1-6 Designations replace Yes, NO*, NO**, NO, NR)
  - Ratings of other recognized rating organizations will be translated directly into an NAIC Designation. **The SVO staff will have discretionary authority to downgrade ratings of other organizations but not to upgrade**.

Chronology - The modern era

- **1992**
  - Relationship to Ratings of NRSRO – NAIC guidelines and procedures promulgated by the TF permit the SVO to incorporate or adopt work product of NRSROs or other reliable securities research organizations in lieu of determining an independent valuation for a security. The P&P has a conversion table but it does not imply an equivalency between NAIC Designations and NRSRO ratings.
    The SVO retains *absolute discretion* to apply a lower Designation.
- **1996 –**
  - Differentiation between public and private ratings
  - Public ratings methodologies generally translated automatically but can be downgraded
  - Private ratings subject to full review

Chronology - The modern era

- **1997**
  - **Non Equivalency**
    - The NAIC uses NRSRO ratings in order to conserve limited regulatory resources and to obtain publicly available high quality credit opinions.
    - While NAIC Designations reflect the staff's opinion about credit risk, the staff must address concerns unique to the regulatory community.
    - Nothing in this manual should be interpreted as implying that the methodologies by which traditional or special NRSRO ratings are produced are identical to the manner in which the SVO considers credit risk for regulatory purposes, or to imply automatic equivalency of NAIC Designations with the ratings of NRSROs.

2000 - Provisional FE P&P provisions

- **An insurance company must file all securities with the SVO except those securities that meet, and continue to meet, the conditions of either Paragraph (1), (2) or (3) below**.

1. Bonds, other than Asset-Backed and Residential Mortgage-Backed Securities, that:
   a) **rated and monitored by two or more NRSROs, with no lower rating than the equivalent of an NAIC 2 Designation by any of the NRSROs, or rated and monitored by only one NRSRO, with a rating the equivalent of an NAIC 1 Designation**
   b) Additional requirements: Issued by a U.S. entity; pays U.S. dollars; P must be repaid in full by fixed maturity date(s); etc.
2. ABS and RMBS
   a) **rated and monitored by two or more NRSROs, with no lower rating than the equivalent of an NAIC 2 Designation by any of the NRSROs, or (ii) rated and monitored by only one NRSRO, with a rating the equivalent of an NAIC 1 Designation**
   b) Are supported: by 1-4 family residential mortgages; auto loan/lease; credit card receivables; manufactured housing contracts; RV loans; aircraft, boat, railcar, truck, computer, office equipment loan/lease; home equity loans; student loans; healthcare receivables
   c) Timing and amount of cash flows available to make bond payments are dependent on the timing and amount of cash flows of underlying assets and no other factors, except for third party guarantees

2000 - Provisional FE P&P provisions

Provisional Exemption for Certain NRSRO Rated Securities

- NOTE: This Section sets forth **provisional filing exemptions for certain securities that are rated by an NRSRO in the equivalent of the NAIC 1 and 2 Designation categories**. Because these securities will not be filed with the SVO, the **SVO will not be able to monitor any innovation or regulatory risk** in these securities. It will be the responsibility of the insurance company, in accordance with the general guidelines set forth in Paragraph (A) below, to determine when an NRSRO rated security that otherwise meets the provisional exemption criteria should be filed for credit, structural, regulatory or other analysis.

2000 - Provisional FE P&P provisions

- Provisional exemption does not limit the authority of the SVO to require filings with respect to any security that is otherwise provisionally exempt at any time for the purpose of reviewing the provisions, terms, covenants or structural features of the security and designating the quality of the security. Upon completion of such review, the SVO is authorized to report its finding and recommendations to an appropriate working group of the VOS/TF.

2000 - Provisional FE: Why?

- **1996 Joint Trade Letter to VOSTF**
  - Focus on SVO inefficiency
  - SVO's limited resources stretched
  - Recommended insurers not need to file non-structured securities rated IG by NRSRO
- **Securities Valuation Office Oversight Working Group of the Valuation of Securities Task Force**
  - Created June 1996
  - Mechanism for industry to bring concerns about SVO
  - To monitor SVO operations

Provisional FE: Why?

- **1997 - SVO Efficiency and Effectiveness Project**
  - Conducted by SVOOWG
  - Industry dissatisfied with SVO efficiency
  - Intended goal to increase usage by SVO of NRSRO ratings

Provisional FE: Why?

- **KPMG Peat Marwick Report and SVO (EX1) Subgroup Study**
- KPMG produced independent report of the SVO (at behest of NAIC)
- SVO Subgroup conducted a study in response
  - Adopted and rejected some of KPMG's recommendations
- Both report and study were presented to regulator-only sessions.
- Based on subsequent minutes: the reports recommended greater reliance on ratings and provided a basis for PE, likely due to the SVO efficiency and resource problems at that time

Provisional FE: Why?

- Trade Letter tried to address TF and SVOOWG concerns:
  - Private placement - minority of insurer investments, may require additional due diligence
  - The proposal does not affect the SVO's ability to request information about a security when it believes it's necessary
  - Ratings shopping – not a concern
    - NRSROs judged by quality of ratings

Provisional FE: Why?

Ideas discussed by regulators, industry and staff:

- Ratings shopping
  - Single AAA threshold may promote it
  - It's an NRSRO accreditation problem rather than an FE problem
  - **Moody's Investors Services**
    - Noted that ratings creep may become a problem if rating agency ratings are used for regulatory purposes
    - The issuer places more emphasis on receiving a higher rating rather than an accurate rating when the rating is tied to regulatory purposes
    - Regulatory reliance would have more impact in the less liquid markets including private placements and structured securities

Provisional FE: Why?

Concerns of regulators, industry and staff:

- Will limit SVO's ability to spot market development; SVO "eyes and ears" function
- SVO analyst warned of recent development of potentially riskier "Subprime" asset class
- Which ABS assets should be included?
- Should/can NRSROs be differentiated?
  - SVO doesn't do it because it would need to be in position to objectively evaluate them
  - SVOOWG should address NRSRO concerns directly with NRSROs
  - 1994 Federal Reserve Report: "Differences [between rating agencies] can be highly problematic for ratings-based regulations in which the ratings of any two NRSROs are substitutable."

Provisional FE: Why?

- **1999** Industry produced FAQ for Provisional FE roll-out
  - Q3: Why does the language say "provisionally exempt"?

    Insurers have no irrevocable "right" to exemption from filing of securities. The state insurance department regulators may monitor insurer compliance with the filing exemption as part of their examination process. **The NAIC/SVO, as well as state regulators, will have the authority to request filings of securities that are provisionally exempt from filing requirements**.

Full FE - 2004

- **Provisional FE became effective January 1, 2000**
- **2000**
  - The SVOOWG charged SVO and interested parties with analyzing feasibility of using non-NRSRO ratings for assignment of NAIC Designations for regulatory purposes.
    - Arguments against - Task Force relied on SEC recognition of NRSROs because SVO didn’t have staff to analyze and determine status for each rating agency
- **2001**
  - Proposal for Subsequently Exempt (SE) securities which would exempt certain securities with optionality from annual update
- **2002**
  - Proposal that SVO should review each security once and then define <u>class of securities</u> which no longer need to be reported

Full FE

- **March 2003 – FE Proposal**
  - **Exempt all NAIC 1 and 2 securities** (ignore current PE limitations)
  - **FE for NAIC 3 - 6**
  - **Find an alternative to SVO review of NR securities i.e. insurers self-designate**
- **Rationale**
  - NRSRO ratings are sufficient to establish quality, particularly multiple rated securities, little regulatory risk
  - New SVO Research Unit (created as part of Efficiency and Effectiveness Project) was intended to play main role in SVO "eyes and ears" function. Limited SVO resources should be direct there.
  - Ratings focus on credit risk; SVO could focus on other non-credit risks affecting solvency
  - Self-designation would make SVO more efficient
  - NAIC had power to withdraw NRSROs from FE eligibility if it didn't meet regulatory purposes

Full FE

- **Arguments against proposal**
  - More volatility in Below IG securities
  - NAIC Designations don’t match ratings exactly
  - Self-reporting
    - Self-regulation doesn’t work; competitive business pressures compromise it
    - Investors are focused on risk and return; regulation’s approach to quality may differ
    - Would lead to inconsistency

Full FE

- **December 2003 – Full FE adopted for 2004 implementation**
  - **NAIC 1-6 scoped in**
  - **ABS/RMBS/Structured included**
  - **Principal only ratings excluded from exemption**
  - **Further discussion on Private Letter Ratings likely, but included in FE for the time being**

Since FE

- Investments classified as ineligible for FE
  - SCA and related party
  - Catastrophe-linked bonds
  - Funds
  - Regulatory transactions
  - Replication (synthetic asset) transactions
  - Mortgage referenced securities
  - Structured notes
  - Principal protected securities
  - CTLs that are mortgage loans in scope of SSAP No. 37
  - Ground Leases that are mortgage loans in scope of SSAP No. 37
  - Residual tranches
- RMBS/CMBS (soon CLOs) Designated by Structured Securities Group

TO: Carrie Mears, 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)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

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

RE: SAPWG Referral - Schedule BA Proposal for Non-Bond Debt Securities

DATE: October 27, 2023

Summary: The Statutory Accounting Principles (E) Working Group (SAPWG) submitted a referral to the Valuation of Securities (E) Task Force (VOSTF) and Capital Adequacy (E) Task Force (CATF) on SAPWG's proposal to report debt securities that do not qualify as bonds on Schedule BA. A key component of the notice was to highlight that the proposal uses existing Schedule BA reporting provisions for SVO-Assigned NAIC designations in determining RBC.

As noted in the referral, as part of its bond project (Ref #2019-21) SAPWG has adopted a revised bond definition to determine the structures that qualify for bond reporting, either as an issuer credit obligation on a new Schedule D-1-1 or as an asset-backed security on Schedule D-1-2. The new definition and the resulting statutory accounting guidance in SSAP No. 26R—Bonds and SSAP No. 43R—Asset-Backed Securities was adopted during the 2023 NAIC Summer National Meeting with an effective date of January 1, 2025. Revised bond reporting schedules are currently exposed by the Blanks (E) Working Group and those are anticipated to be considered for adoption by the end of the year. Also, during the 2023 Summer National Meeting, the SAPWG exposed accounting and reporting guidance for debt securities that do not qualify as bonds in SSAP No. 21R—Other Admitted Assets and received direction to sponsor a blanks proposal to capture these securities in new reporting lines on Schedule BA - Other Long Term Invested Assets.

Existing Guidance: The Task Force has existing policy in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) in Part One, paragraphs 40 and 99, and instructions to Securities Valuation Office (SVO) in Part Two, paragraphs 209-212, that permit the SVO to assign NAIC Designations to Schedule BA assets "… that have the underlying characteristics of a bond or other fixed income instrument …"

Recommendation: Pursuant to the P&P Manual the SVO is authorized to assign NAIC Designations to investments eligible for reporting on Schedule BA though, according to P&P Manual Part One, Paragraph 32, the assignment of an NAIC Designation does not communicate statutory accounting or reporting opinions. The SVO staff strongly recommends to the Task Force and the Capital Adequacy (E) Task Force the continuation of the existing policy of only allowing the bond risk-based capital factors associated with NAIC Designations assigned by the SVO to investments appropriately reported by insurers on Schedule BA. The nature of the investments on this schedule can vary widely and are often highly bespoke, which demands a higher level of regulatory scrutiny before being granted this favorable treatment. Though we reiterate that the SVO's assignment of an NAIC Designation does not indicate a statutory accounting or reporting opinion. We would further recommend this treatment being uniform across statement types.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-11 Fall NM/03-SAPWG Referral Sch BA/2023-013.02 SVO Review of SAPWG Sch BA Referral v2.docx

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

TO:	Carrie Mears, Chair Representative, Valuation of Securities (E) Task Force Tom Botsko, Chair Representative, Capital Adequacy (E) Task Force
FROM:	Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group Kevin Clark, Vice-Chair of the Statutory Accounting Principles (E) Working Group
DATE:	August 28, 2023
RE:	SAPWG Schedule BA Proposal for Non-Bond Debt Securities

The purpose of this referral is to notify the Valuation of Securities (E) Task Force and Capital Adequacy (E) Task Force of the Statutory Accounting Principles (E) Working Group's (SAPWG) proposal to report debt securities that do not qualify as bonds on Schedule BA. A key component of this notice is to highlight that the proposal uses existing Schedule BA reporting provisions for SVO-Assigned NAIC designations in determining RBC.

As preliminary information, as part of the bond project (Ref #2019-21) the SAPWG has been working on a revised bond definition to determine the structures that qualify for bond reporting, either as an issuer credit obligation on a new Schedule D-1-1 or as an asset-backed security on Schedule D-1-2. The new definition and the resulting statutory accounting guidance in *SSAP No. 26R—Bonds* and *SSAP No. 43R—Asset-Backed Securities* was adopted during the 2023 NAIC Summer National Meeting with an effective date of January 1, 2025. Revised bond reporting schedules are currently exposed by the Blanks (E) Working Group and those are anticipated to be considered for adoption by the end of the year. Also, during the 2023 Summer National Meeting, the SAPWG exposed accounting and reporting guidance for debt securities that do not qualify as bonds in *SSAP No. 21R—Other Admitted Assets* and received direction to sponsor a blanks proposal to capture these securities in new reporting lines on Schedule BA - Other Long Term Invested Assets.

The key aspect of this referral is to highlight that the blanks proposal for the new reporting lines intends to divide the debt securities that do not qualify as bonds into separate reporting lines based on whether they have NAIC designations assigned by the SVO from those securities with NAIC designations not assigned by the SVO or that do not have designations. The intent of this reporting is to permit debt securities that do not qualify as bonds, for which the SVO has assigned an NAIC designation, to receive the RBC factor that would have been received if the security had been reported on the bond schedule with an equivalent designation. Although the debt security does not qualify for reporting as a bond due to structure, if the SVO has assessed credit quality with the issuance of an NAIC designation, then the proposed reporting allows for a fixed income RBC factor.

Washington, DC 444 North Capitol Street NW, Suite 700, Washington, DC 20001-1509 p | 202 471 3990
Kansas City 1100 Walnut Street, Suite 1500, Kansas City, MO 64106-2197 p | 816 842 3600
New York One New York Plaza, Suite 4210, New York, NY 10004 p | 212 398 9000
www.naic.org

To illustrate an example where a debt security may not meet the bond definition but may warrant a fixed income RBC factor, one of the key principles is that, for debt securities that rely on underlying collateral for repayment, underlying collateral must produce meaningful cash flows to service the debt to qualify as a bond. If the debt security relies on the underlying collateral retaining its **value** to repay the debt (e.g. through sale of collateral or refinancing), then it does not qualify to be reported as a bond. For example, a debt security could be secured by non-cashflow-producing real estate at a 50% loan-to-value. While it would not qualify to be reported as a bond, its characteristics are consistent with that of a mortgage loan, and may warrant a fixed income RBC charge.

This proposal does not intend to hinder the Capital Adequacy (E) Task Force's ability to assess these debt securities and determine the appropriate RBC factor, it simply intends to allow an avenue for certain assets to receive a fixed income factor until the Capital Adequacy (E) Task Force decides if a separate project is needed to review and assess RBC factors for these debt securities. As noted, it is only proposed to be provided for the securities that have an SVO-assigned designation, which is consistent with other Schedule BA lines for which designations influence RBC. Note also that prior to the effective date of the bond definition, these securities are reported as bonds on Schedule D and receive bond RBC factors based on NAIC designation (whether from a credit rating provider for filing exempt securities, or an SVO assigned designation). After adoption, non-qualifying debt securities with NAIC designations that are not assigned by the SVO or that do not have designations are proposed to receive the RBC factor for "other" Schedule BA assets. This is also consistent with the Schedule BA lines that have these separate reporting determinants. Since only reporting entities that file using the life blank can receive RBC reductions for reporting SVO-assigned NAIC designations on Schedule BA, this provision is intended to only apply to those entities until / unless the Capital Adequacy (E) Task Force, and related RBC Working Groups, incorporate changes to provide those capabilities to non-life entities.

The intent of this referral is to inform the Task Forces of the current reporting proposal and request the Valuation of Securities (E) Task Force to assess whether additional guidance is needed within the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* to permit or govern the assignment of SVO-Assigned NAIC Designations for debt securities that do not qualify as bonds.

The following illustrates the proposed Schedule BA reporting lines for these debt securities. A blanks proposal will be developed and exposed by the Blanks (E) Working Group to incorporate these revisions, as well as changes to the AVR with instructions that specifies the mapping from Schedule BA to the AVR for life RBC purposes.

- Debt Securities That Do Not Qualify as Bonds
  - Debt Securities That Do Not Reflect a Creditor Relationship in Substance
    - NAIC Designation Assigned by the Securities Valuation Office (SVO)
      - Unaffiliated
      - Affiliated
    - NAIC Designation Not Assigned by the Securities Valuation Office (SVO)
      - Unaffiliated
      - Affiliated
  - Debt Securities That Lack Substantive Credit Enhancement
    - NAIC Designation Assigned by the Securities Valuation Office (SVO)
      - Unaffiliated

Affiliated

NAIC Designation Not Assigned by the Securities Valuation Office (SVO)

Unaffiliated

Affiliated

Debt Securities That Do Not Qualify as Bonds Solely to a Lack Of Meaningful Cash Flows

NAIC Designation Assigned by the Securities Valuation Office (SVO)

Unaffiliated

Affiliated

NAIC Designation Not Assigned by the Securities Valuation Office (SVO)

Unaffiliated

Affiliated

The Working Group appreciates your time and looks forward to your response. If you have any questions, please contact Dale Bruggeman, or Kevin Clark, SAPWG Chair and Vice Chair, with any questions.

Cc: Julie Gann, Robin Marcotte, Jake Stultz, Jason Farr, Wil Oden, Charles Therriault, Marc Pearlman, Eva Yeung, Dave Fleming, Crystal Brown, Maggie Chang

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-11 Fall NM/03-SAPWG Referral Sch BA/2023-013.01 SAPWG to VOSTF & CAPTF - Schedule BA (2023-08-28).docx

SVO

NAIC
NATIONAL ASSOCIATION OF
INSURANCE COMMISSIONERS

TO: Carrie Mears, 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)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

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

RE: Proposed Amendment to Update the Definition of an NAIC Designation in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)

DATE: October 31, 2023

Summary –

NAIC Designations are currently explained and defined in both Parts One and Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). The SVO proposes both consolidating these explanations and definitions in Part One only and clarifying the meaning of an NAIC Designation including their use, purpose and risks addressed.

When the new format for the P&P Manual was adopted on November 16, 2018, and published in the new format on April 7, 2019, several changes were made in an attempt to simplify the P&P Manual. It has since become apparent that some of those changes have led to the interpretation that there are two meanings of an NAIC Designation: one meaning, found in Part One, applicable to all securities, whether assigned NAIC Designations pursuant to the Filing Exemption process or by the Securities Valuation Office ("SVO") and a second meaning, found in Part Two, applicable only to securities assigned NAIC Designations by the SVO. It is the SVO staff's belief that there is only one definition of an NAIC Designation and that it is applicable however the NAIC Designation is assigned. To that end, the revisions proposed in this amendment have consolidated the instructions that define an NAIC Designation to make a single uniform definition and includes updates to the definition to address questions and concerns raised about the purpose of NAIC Designations versus credit rating provider ratings.

At the Summer National Meeting held on Aug. 14, 2023, the Task Force discussed an initial draft of a proposed amendment to the P&P Manual updating the definition of an NAIC Designation. The Task Force directed the SVO staff to consider the feedback from Task Force members and interested parties and update the proposal. The revised amendment in this memorandum reflects the actionable comments received from Task Force members and interested parties, including:

1. Creation of a concise definition of an NAIC Designation which reflects, along with credit quality:

    a. Any inconsistencies with the existing regulatory assumption that a fixed income instrument requires scheduled payments of interest and full repayment of principal on a date certain; and

    b. Loss given default and/or "tail" risk, where appropriate; and

2. Removal of the application of Subscript S for other non-payment risks.

Proposed Amendment - The proposed text changes to the P&P Manual are shown below with additions in red font color and deletions in ~~red strikethrough~~, as it would appear in the 2022 P&P Manual format. Editing notes have been added with *[ ]* to explain section moves. New text is highlighted in yellow.

(VERSION WITH CHANGES DISPLAYED AND ADDITIONS HIGHLIGHTED)

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

POLICIES PERTAINING TO SVO AND SSG OPERATIONS

. . .

~~**NAIC Designations**~~

[Editing note: select portions moved from Part One, paras. 37-39 to the new "NAIC Designations" section within Part One]

~~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.~~
- ~~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.~~

~~38. The result of the SVO's credit analysis, expressed as an opinion of credit quality by assignment of an NAIC Designation shall be further expanded into NAIC Designation Categories as, and for the purposes, discussed in this Manual.~~

~~**NOTE**: See "Production of NAIC Designations" in Part Two.~~

~~**Other Non-Payment Risk in Securities**~~

~~39. The result of the SVO's analysis of securities for other non-payment risk is expressed by the assignment of an NAIC Designation Subscript S and the application of the notching procedures described below.~~

~~**NOTE**: See "NAIC Designation Subscript S" and "SVO Notching Guidelines" in Part Two.~~

NAIC DESIGNATIONS

Regulatory Objective

88. An objective of the VOS/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. NAIC Designations are ~~The SVO is~~ required to reflect ~~identify securities that contain~~ such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer.
[Editing note: Moved from Part One, para. 90]

~~**NOTE:** See "NAIC Designation Subscript S" in Part Two.~~

Definition~~s~~

89. NAIC Designations represent opinions of gradations credit quality identified by the NAIC 1 through NAIC 6 symbols (as modified by NAIC Designation Categories) which indicate the highest quality (least risk) to the lowest quality (greatest risk), respectively, and which reflect the likelihood of timely and full payment of principal and scheduled periodic interest, in accordance with the regulatory objectives explained above, and the likelihood of principal and/or interest payment default. Where appropriate for a given investment, NAIC Designations shall reflect "tail risk" and/or loss given default. NAIC Designations and Designations Categories ~~may be notched to~~ shall reflect the position of the specific liability in the issuer's capital structure, and other non-payment risks or non-payment mitigants. *[Editing Note: moved from Part One, para. 37]* NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk. *[Editing Note: moved from Part One, para. 37]*

Use and Purposes of NAIC Designations

90. **NAIC Designations** are proprietary symbols of the NAIC. The SVO, the SSG and, under certain circumstances, insurers, produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/TF in this Manual. *[Editing Note: Moved from Part Two, para. 18.]* The 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. *[Editing Note: moved from Part One, para. 37]* 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. *[Editing Note: moved from Part One, para. 37]*

91. **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 *[Editing note: Moved from Part Two, para. 18]* and 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. *[Editing note: Moved from Part One, para. 37]* ~~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. 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.~~ *[Editing note: Deleted from Part Two, para. 18]*

92. **NAIC Designations** must be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) and other NAIC guidance. For example, the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.

93. ~~**NAIC Designation** – Means any one of the gradations of credit quality and credit risk identified by the **NAIC 1** through **NAIC 6** symbols further discussed and defined in this Manual and may reflect notching pursuant to one or both of the notching procedures discussed in this Manual. NAIC Designations are proprietary symbols of the NAIC to be used by the SVO and SSG or under certain circumstances by an insurer to denote a category or band of credit risk.~~
[Editing note: Originally in Part One, para. 88]

APPLICATION OF NAIC DESIGNATIONS

94. **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 Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 19]

95. **NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An **NAIC 2** obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 20]

96. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 21]

97. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 22]

98. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 23]

99. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 24]

NOTE: See ~~"NAIC Designations,"~~ "Prohibition on Use of NAIC Designation in a Covenant" and "Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force" in Part One; ~~"NAIC Designation Categories" below~~; and "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three.

APPLICATION OF NAIC DESIGNATION CATEGORIES

100. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories~~, as described and defined in this Manual~~.
[Editing note: Moved from Part Two, para. 25]

101. **NAIC Designation Category** – Means and refers to 20 more granular delineations of credit risk in the **NAIC 1** through **NAIC 6** credit risk scale used by the VOS/TF to relate credit risk in insurer-owned securities to a risk-based capital factor assigned by the NAIC Capital Adequacy (E) Task Force. Each delineation of credit risk is represented by a letter (a Modifier) which modifies the NAIC Designation grade to indicate a more granular measure of credit risk within the NAIC Designation grade. The more granular delineations of credit risk are distributed as follows: 7 for the **NAIC 1** Designation grade indicated by the letters A through G; 3 delineations each for each of the NAIC Designation grades **NAIC 2**, **NAIC 3**, **NAIC 4** and **NAIC 5** indicated by the letters A, B and C and 1 delineation for NAIC Designation grade **NAIC 6**. The NAIC Designation Category framework is shown in this Manual. All Modifiers roll up into the respective NAIC Designation grade as they are a subset of them.

~~NOTE: See "Production of NAIC Designations" in Part Two.~~
[Editing Note: Moved from Part One, para. 89.]

102. **NAIC Designation Categories** are a subset of **NAIC Designations** and are used by the VOS/TF to link the NAIC risk-based-capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
1		A		1.A
1		B		1.B
1		C		1.C
1		D		1.D
1		E		1.E
1		F		1.F
1		G		1.G
2		A		2.A
2		B		2.B
2		C		2.C
3		A		3.A
3		B		3.B
3		C		3.C
4		A		4.A
4		B		4.B
4		C		4.C
5		A		5.A

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
5		B		5.B
5		C		5.C
6				6

[Editing note: Moved from Part Two, para. 26]

103. NAIC Designations and Designation Categories may be adjusted in accordance with the ~~notching~~ procedures described in this Manual ~~below~~ so that an NAIC Designation and Designation Category for a given security reflects the position of that specific security in the issuer's capital structure, and other non-payment risks or non-payment mitigants. ~~NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risks in the specific security in accordance with the procedures described in this Manual associated with NAIC Designations Subscript S.~~
[Editing note: Moved from Part Two, para. 18]

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION

104. An insurance company that self-assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.
[Editing note: Moved from Part Two, para. 27]

105. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met. *[Editing note: Moved from Part Two, para. 28]*

106. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation. *[Editing note: Moved from Part Two, para. 29]*

107. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.
[Editing note: Moved from Part Two, para. 30]

108. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation. *[Editing note: Moved from Part Two, para. 31]*

109. Securities that are residual tranches or interests, as defined in *SSAP 43R – Loan Backed and Structured Securities*, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.
[Editing note: Moved from Part Two, para. 32]

~~**NOTE REGARDING RESIDUAL TRANCHES OR INTERESTS**: For 2021 year-end reporting only, residual tranches or interests previously reported on Schedule D-1: Long-Term Bonds shall be permitted to be reported on Schedule D-1 with an NAIC 6* Designation, however an NAIC 5GI is not permitted.~~

NOTE: The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.
[Editing note: Moved from Part Two, para. 32]

NAIC General Interrogatory

110. **NAIC 5GI** and NAIC Designation Category **NAIC 5.B GI** is assigned by an insurance company to certain obligations that meet all of the following criteria:

- Documentation necessary to permit a full credit analysis of a security by the SVO does not exist or an NAIC CRP credit rating for an FE or PL security is not available.
- The issuer or obligor is current on all contracted interest and principal payments.
- The insurer has an actual expectation of ultimate payment of all contracted interest and principal.

[Editing note: Moved from Part One, para. 91]

NAIC PLGI

111. Effective July 1, 2018, insurance companies shall be responsible for providing the SVO copies of private rating letters for PL securities, where applicable, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs. For PL Securities issued prior to January 1, 2018, if an insurance company cannot provide a copy of the rating letter to the SVO due to confidentiality concerns and the rating is not included in a CRP credit rating feed (or other form of direct delivery from the NAIC CRP), the insurer shall report such securities on such securities' General Interrogatory to be developed for this purpose (i.e., a PLGI security). *[Editing note: Moved from Part One, para. 92]*

Monitoring of SVO-Designated Securities

112. The SVO shall monitor, on an ongoing basis through the information provided by insurers as required by the Material Credit Events Filing described in this Manual, improvements and deterioration of credit quality of securities that are not filing exempt. *[Editing note: Moved from Part One, para. 93]*

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

~~PRODUCTION OF NAIC DESIGNATIONS~~ [EDITING NOTE: MOVED TO PART ONE "NAIC DESIGNATIONS".]

~~NAIC DESIGNATIONS~~

18. ~~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. 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. 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.~~

19. ~~**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 Regulation Standards and Accreditation Program.~~

20. ~~**NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An **NAIC 2** obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

21. ~~**NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

~~22. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

~~23. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

~~24. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

~~**NOTE**: See "NAIC Designations," "Prohibition on Use of NAIC Designation in a Covenant" and "Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force" in Part One; "NAIC Designation Categories" below; and "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three.~~

~~NAIC DESIGNATION CATEGORIES~~

~~25. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories, as described and defined in this Manual.~~

~~26. NAIC Designation Categories are a subset of NAIC Designations and are used by the VOS/TF to link the NAIC risk-based-capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.~~

~~NAIC Designation~~	~~+~~	~~NAIC Designation Modifier~~	~~=~~	~~NAIC Designation Category~~
~~1~~		~~A~~		~~1.A~~
~~1~~		~~B~~		~~1.B~~
1		~~C~~		1.C
1		~~D~~		~~1.D~~
1		~~E~~		1.E
1		~~F~~		~~1.F~~
1		~~G~~		~~1.G~~
2		~~A~~		2.A
2		~~B~~		2.B
2		~~C~~		2.C
3		~~A~~		3.A
3		~~B~~		3.B
3		~~C~~		3.C
4		~~A~~		4.A
4		~~B~~		4.B
4		~~C~~		4.C
5		~~A~~		5.A
5		~~B~~		5.B
5		~~C~~		5.C
6				~~6~~

~~NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION~~

~~27. An insurance company that self-assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.~~

~~28. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met.~~

~~29. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation.~~

~~30. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.~~

~~31. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.~~

~~32. Securities that are residual tranches or interests, as defined in *SSAP 43R – Loan Backed and Structured Securities*, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.~~

~~**NOTE REGARDING RESIDUAL TRANCHES OR INTERESTS**: For 2021 year-end reporting only, residual tranches or interests previously reported on Schedule D-1: Long-Term Bonds shall be permitted to be reported on Schedule D-1 with an NAIC 6* Designation, however an NAIC 5GI is not permitted.~~

~~**NOTE**: The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.~~

~~NAIC DESIGNATION SUBSCRIPT S~~

~~Description of Other Non-Payment Risk~~

~~33. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.~~

~~34. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.~~

~~35. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a schedules basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).~~

~~36. Using the broad concepts identified above, non-payment risk may be present when:~~

- ~~A reporting insurance company takes on a participatory risk in the transaction;~~

  ~~Illustration – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.~~

- ~~The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;~~

  ~~Illustration – A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.~~

  ~~Illustration – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity dates (e.g., a mandatory redemption) or that states a maturity equal to~~

~~*or exceeding 40 years*~~.

~~37. Agrees to an exposure that has the potential to result in a significant delay in payment of contractually promised interest and/or a return of principal in an amount less than the original investment.~~

~~Meaning of the Subscript S Symbol~~

~~38. An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows:~~ **~~NAIC 2S~~**~~.~~

~~39. The SVO shall assess securities for other non-payment risk:~~

- ~~Routinely, for any security or financial product filed with the SVO.~~
- ~~As part of the analysis of a security or financial product submitted to the SVO under the RTAS – Emerging Investment Vehicle process discussed in of this Manual.~~
- ~~When requested to do so by any state insurance regulator acting pursuant to this Manual, and:~~

~~When requested by the VOS/TF; or~~

~~In support of any other NAIC group engaged in the analysis of investment risks in new securities.~~

~~**NOTE**: See "NAIC Designation Subscript S" in Part One.~~

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-11 Fall NM/04-Definition of NAIC Designation/2022-012.08 P&P Updated Def of NAIC Desig_Revisionv9.docx

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Carrie Mears, 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)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)
Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

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: November 3, 2023

Summary: At the Summer National Meeting held on Aug. 14, 2023, the Task Force discussed an initial draft of a proposed amendment to the P&P Manual authorizing the procedures for the SVO's discretion over NAIC designations assigned through the filing exemption (FE) process. The Task Force directed the SVO staff to consider the feedback from Task Force members and interested parties and update the proposal. The revised amendment in this memorandum reflects the actionable comments received from Task Force members and interested parties that align with the following charges given to the Task Force from the Financial Condition (E) Committee (emphasis added):

- <u>Identify potential improvements to the filing exempt (FE) process</u> (the use of credit rating provider [CRP] ratings to determine an NAIC designation) to ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives.

- <u>Implement policies to oversee the NAIC's staff administration of rating agency ratings</u> used in NAIC processes, <u>including staff's discretion over the applicability of their use</u> in their administration of FE.

- <u>Establish criteria to permit staff's discretion over the assignment of NAIC designations for securities subject to the FE process</u> (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.

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

The revised amendment incorporates the following process steps, many of which were requested by interested parties:

1) SVO staff identifies a FE security with an NAIC Designation determined by a rating that appears to be an unreasonable assessment of risk.
2) SVO Senior Credit Committee (SCC) meets to determine if it agrees that the rating appears an unreasonable assessment of risk and, if so, places the security "Under Review".
3) If the SVO SCC votes to put the security "Under Review" an information request will be sent through VISION to insurers that hold that security in their VISION portfolio and an the SVO Administrative Symbol assigned to identify them in VISION and AVS+.
4) If the information request is not responded to, the SVO may reach out to the domiciliary Chief Financial Examiner.
5) Upon receipt of all necessary documentation through the information request, the SVO will then perform a full analysis of the security and coordinate with the interested insurer(s) on any questions or issues the SVO may have about the security.
6) SVO SCC re-convenes and determines, based on its full analysis of all necessary information, whether the FE NAIC Designation is three (3) or more notches different than the SCC's opinion.
7) If the SVO SCC opinion differs from the FE produced NAIC Designation Category by a material three (3) or more notches the specific CRP rating(s) for that security will be removed from FE.
8) The SCC will present its analysis to a sub-group of the Task Force to provide oversight over the FE removal process and enable the Task Force to provide feedback to the SVO.
9) If there are no alternative CRP ratings, the SVO SCC's assessment will be entered into VISION. If an alternative CRP rating is subsequently received, it will be incorporated into the FE process, if applicable.
10) If the SVO SCC assesses the issue is part of a recurring pattern, the SVO Director will inform the chair and decide if an issue paper, referral or amendment is needed.
11) An anonymized summary of each unique issue or situation will be published on the SVO webpage or some other insurer accessible location for transparency.
12) An insurer may appeal to the Task Force chair if they believe the SVO did not follow the procedures outlined in the P&P Manual.
13) If an insurer(s) wishes to appeal the SVO SCC's analytical assessment, it may request the NAIC's IAO to contract, at the insurer(s) expense, with an independent third-party acceptable to the NAIC IAO to perform a blind review of the security (e.g. without knowledge of the SCC's, insurer's or CRP's assessment) with the information provided through the information request. If the independent third-party review results in an NAIC Designation Category that is one (1) or less notches different from the FE produced NAIC Designation Category, then the SVO SCC's opinion will be overridden by the reinstatement

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

of the CRP rating(s). If the independent third-party review results in an NAIC Designation Category that is more than one (1) notch different from the FE produced NAIC Designation Category, then the SVO SCC's opinion will remain.

14) The SVO will identify through SVO Administrative Symbols when a CRP rating(s) has been removed from the Filing Exemption process for a security.
15) At the Spring National Meeting, the SVO Director will summarize FE discretion actions take for the preceding year.

Recommendation: It is expected that implementation of this process will require enhancements to NAIC's VISION and AVS+ applications. Funding for the application enhancements in the amendment, if adopted, will need to be approved by the Executive (EX) Committee and the initiative will need to go through the NAIC's development process. It could take 1-2 years before this proposal can be fully implemented. The SVO recommends adoption of this proposed amendment authorizing the procedures for the SVO's discretion over NAIC Designations assigned through the FE process with an effective date of January 1, 2025. The effective date can be amended, if needed, because of the dependency mentioned. The proposed text changes to P&P Manual are shown below with additions in red underline, and deletions in ~~red strikethrough~~ as it would appear in the 2022 P&P Manual format.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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

…

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 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.

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 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.

…

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

SVO ORGANIZATION

…

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: …

- **UR** means the NAIC Designation assigned pursuant to the filing exemption process is under review by the NAIC's Investment Analysis Office.
- **DR** means that one or more otherwise Eligible NAIC CRP Credit Ratings have been removed from the filing exemption process when determining the NAIC Designation through the IAO's discretion procedures.

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 Category assigned through the filing exemption process which it thinks is not a reasonable assessment of risk of the security for regulatory purposes.

(Note: The guidance in this part is effective as of January 1, 2025, but this date may be amended if additional time is needed to implement the necessary NAIC technological enhancements to IAO systems.)

Request for Information

165. The IAO staff will bring to the attention of the NAIC IAO Senior Credit Committee (SCC) any filing exemption-eligible security assigned an NAIC Designation Category equivalent through the automated filing exemption process as being a security under review if (i) a state insurance regulator notifies the IAO staff that it has determined the NAIC Designation Category equivalent may not be a reasonable assessment of risk of the security for regulatory purposes, or (ii) the IAO staff, in its opinion, determines that the NAIC Designation Category equivalent may not be a reasonable assessment of risk of the security for regulatory purposes. State insurance regulator notification pursuant to this section does not negate the authority of state insurance regulators under "States May Require a Filing of Exempt or Other Transactions" in Part One of this Manual.

166. The SCC will convene to determine if, in its opinion, the NAIC Designation Category assigned pursuant to the filing exemption process is a reasonable assessment of risk of the security for regulatory purposes. As part of its review, the SCC may consider observable factors, among others, 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. If the SCC's opinion is that the assigned NAIC Designation Category is likely a reasonable assessment of risk of the security for regulatory purposes, no further action will be taken at that time. If the SCC's opinion is that the assigned NAIC Designation Category is likely not a reasonable assessment of risk of the security for regulatory purposes, an information request will be initiated and the security will be identified as "Under Review".

167. The IAO will notify insurance company holders of a security determined to be a Filing Exempt Security "Under Review" by issuing an information request and publishing a separate SVO Analytical Department Symbol of "UR" for Under Review in NAIC systems for that security that will not be reported on the statutory investment schedules. The purpose of the information request is to provide the IAO staff with sufficient information to perform a full analysis of the security. Consistent with the informational deficiencies instructions in this Manual, security information consistent with an Initial Filing should be provided to the IAO within 45 days unless an extension has been granted to the insurance company by the IAO, not to exceed 90 days in total from the date that the IAO issues an information request. The IAO may contact the insurance company's domiciliary chief financial regulator for assistance after the initial 45 days if there has been no meaningful response. If after 90 days additional information equivalent to a complete filing has not been provided to the IAO, the IAO may proceed with removal of the otherwise Eligible NAIC CRP Credit Rating(s) from the Filing Exempt process.

Full Review

168. At any time during the information request submission period or during the IAO's subsequent analysis of the security, the insurance company holders of the security are encouraged to provide additional information to the IAO such as their internal analysis, presentations from the issuer, meetings with the issuer's management team and any other information that may be useful or persuasive in the analysis of the security. The IAO will coordinate with the interested insurer(s) on any questions or issues it may have about the security.

169. Upon satisfactory receipt of the information through the information request, the IAO will perform a full analysis of the security during which time the SVO Analytical Department Symbol "UR" will remain in place but it will not be reported on the statutory investment schedules.

Materiality Threshold for IAO Analysis

170. Upon completion of the IAO's analysis, the SCC will reconvene to determine whether the NAIC Designation Category assigned through the automated filing exemption process is materially different from the SCC's assessment of the security's risk.

171. 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 remove an otherwise Eligible NAIC CRP Credit Rating from the Filing Exemption process only if the SCC determines, based upon its review, that the Eligible NAIC CRP Credit Rating for the security is three (3) or more notches different than the IAO's assessment (e.g. NAIC Designation Category 1.G versus 2.C) (the "Materiality Threshold").

Valuation of Securities (E) Task Force Oversight

172. The SCC shall discuss and explain its analytical basis for any Eligible NAIC CRP Credit Rating being removed from Filing Exemption eligibility with a sub-group of the VOS/TF (the composition of which to be determined by the VOS/TF chair) for so long as the VOS/TF chair deems such meetings necessary.

173. If the SCC identifies that there is a recurring analytical pattern or concern, the IAO Director(s) will inform the VOS/TF chair and decide if an issue paper, referral, amendment to this Manual or some other action is needed.

Assignment of NAIC Designation Category

174. If the IAO SCC determines that the NAIC Designation Category assigned pursuant to the Filing Exemption process *does not* meet the Materiality Threshold, the Eligible NAIC CRP Credit Rating shall remain eligible for Filing Exemption, the SVO Analytical Department Symbol "UR" 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 shall not preclude the IAO from placing the same Eligible NAIC CRP Credit Rating under analytic review at a later date following a subsequent review should changing conditions warrant.

175. If the IAO SCC determines that the NAIC Designation Category assigned pursuant to the Filing Exemption process *does* meet the Materiality Threshold, the IAO will block the otherwise Eligible NAIC CRP Credit Rating in NAIC systems to prevent it from using the automated Filing Exempt Securities Process.

176. If an Eligible NAIC CRP Rating has been removed from Filing Exemption eligibility for a security according to this section and the security has another Eligible NAIC CRP Rating which has not been removed or one is subsequently received, then the security can receive its NAIC Designation Category through the Filing Exemption process based on the other Eligible NAIC CRP Rating(s). If there is no alternate Eligible NAIC CRP Rating in NAIC systems, the SCC's NAIC Designation Category will be entered into NAIC systems to assign an NAIC Designation Category to the security.

177. As noted in this Manual, any insurer that owns a security for which the SVO has provided an NAIC Designation, a classification or a valuation, may request a clarification of the decision from the SVO (Requests for Clarification of SVO Decisions).

Appeal to the VOS/TF

178. An insurer that thinks the IAO did not make its Filing Exemption determination regarding the insurer's security in accordance with the procedures in this Manual it may request consideration of the concern by the VOS/TF pursuant to "Review of SVO Decisions by the VOS/TF" in this Manual.

Analytical Appeal to an Independent Third-party

179. An insurer that disagrees with the SCC's final analytical assessment may request, at its own expense, that the NAIC's IAO contract with an independent third-party acceptable to the IAO to perform a blind analysis of the security (e.g. without knowledge of the SCC's, insurer's or CRP's assessment) based upon the information provided through the information request and consistent with the objectives and purposes of an NAIC Designation Category.

180. If the independent third-party's assessment results in an NAIC Designation Category that differs from the NAIC Designation Category assigned pursuant to the Filing Exemption process by no greater than a one (1) notch, the originally assigned NAIC Designation Category will remain in force and the Eligible NAIC CRP Credit Rating remain eligible for Filing Exemption.

181. If the independent third-party's assessment results in an NAIC Designation Category that that differs from the NAIC Designation Category assigned pursuant to the Filing Exemption process by greater than one (1) notch, the SCC's opinion will remain in-force and the Eligible NAIC CRP Credit Rating will remain ineligible for Filing Exemption.

Reinstatement of Filing Exemption Eligibility

182. If an insurer would like the IAO to re-evaluate an Eligible NAIC CRP Credit Rating 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

183. The IAO Director(s) will prepare a summary of the removed from Filing Exemption Eligibility actions take over the prior calendar year.

184. The IAO will also publish an anonymized summary of each unique situation encountered for the securities subject to removal from Filing Exemption Eligibility and publish it on an insurer accessible web location.

185. To facilitate transparency as to the SVO's application of discretion, the SVO Analytical Department Symbols "DR' will be added in NAIC Systems to securities with a blocked otherwise Eligible NAIC CRP Credit Rating(s). The SVO Analytical Department Symbols, "DR" *will be* reported on the insurer's statutory investment schedules for the effected security as SVO Administrative Symbols.

…

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-11 Fall NM/05-SVO Discretion/2023-005.15 P&P SVO Discretion - Revised v4.docx

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Carrie Mears, 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)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)
Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the "P&P Manual") to Incorporate Practical Expedient for PLR Issue Date

DATE: October 27, 2023

Summary: The SVO has been unable to independently source the date attribute Issue Date (e.g. date of legal closing), a necessary input to determine the requirement to provide a private letter rating (PLR) rationale report. The SVO proposes permitting it to apply a practical expedient by assuming that any security subject to the private letter rating guidance that was acquired after January 1, 2022, was issued on or after January 1, 2022, unless documentation showing an earlier issue date is provided.

Recommendation: The SVO recommends adoption of this proposed technical amendment to provide for a practical expedient in situations where the SVO is unable to identify the issue date associated with securities that are subject to the private letter rating filing requirements. The proposed text changes to P&P Manual are shown below with additions in red underline, and deletions in ~~red strikethrough~~ as it would appear in the 2023 P&P Manual format.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

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

…

PL SECURITIES

Effective Date of Verification Procedure for PL Securities

…

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 and an NAIC Designation Category of **NAIC 5.B GI** in accordance with the guidance specified below.
13. For PL Securities acquired on or after January 1, 2022, for which the SVO cannot determine the security's issue date (e.g. date of the legal closing), the SVO may assume as a practical expedient, in the absence of documentation from the insurer showing otherwise, that the issue date was on or after January 1, 2022, for determining the filing requirements for the PL Security.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-11 Fall NM/06-PLR Issue Date/2023-014.01 P&P SVO PLR Issue Date v2.docx

SVO

NAIC
NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Carrie Mears, 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)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

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

RE: Proposed Amendment to Update the Definition of an NAIC Designation in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)

DATE: April 26, 2023

Summary – NAIC Designations are currently explained and defined in both Parts One and Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the "P&P Manual"). The SVO proposes both consolidating these explanations and definitions in Part One only and clarifying the meaning of an NAIC Designation including their use, purpose and risk addressed.

When the new format for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) was adopted on November 16, 2018 and published in the new format on April 7, 2019, several changes were made in an attempt to simplify the P&P Manual. It has since become apparent that some of those changes have led to the interpretation that there are two meanings of an NAIC Designation: one meaning, found in Part One, applicable to all securities, whether assigned NAIC Designations pursuant to the Filing Exemption process or by the Securities Valuation Office ("SVO") and a second meaning, found in Part Two, applicable only to securities assigned NAIC Designations by the SVO. It is the SVO staff's belief that there is only one definition of an NAIC Designation and that it is applicable however the NAIC Designation is assigned. To that end, the revisions proposed in this amendment have consolidated the instructions that define an NAIC Designation to make a single uniform definition and includes updates to the definition to address questions and concerns raised about the purpose of NAIC Designations versus credit rating provider ratings.

Additionally, the SVO recommends consolidating the current "NAIC Designation Subscript S" section in Part Two into the revised NAIC Designation section in Part One because the application of a Subscript S to an NAIC Designation for other non-payment risks signifies a change in the meaning of the NAIC Designation and is a policy of the Task Force.

Recommendation – The majority of the amendment involves moving text from Part Two, the Operational and Administrative Instructions Applicable to the SVO, into Part One, the Policies of the NAIC Valuation of Securities (E) Task Force. Additionally, the amendment would add clarifying language to the newly combined explanation and definition of NAIC Designations. A clean version of the amendment has also been included to simplify the review, with the new text also clearly highlighted.

Proposed Amendment - The proposed text changes to the P&P Manual are shown below with additions in red font color and deletions in ~~red strikethrough~~, as it would appear in the 2022 P&P Manual format. Editing notes have been added with [ ] to explain section moves. New text is highlighted in yellow.

(VERSION WITH CHANGES DISPLAYED AND ADDITIONS HIGHLIGHTED)

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

. . .

~~**NAIC Designations**~~

[Editing note: moved from Part One, paras. 37-39 to the new "NAIC Designations" section within Part One]

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.~~
- ~~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.~~

38. ~~The result of the SVO's credit analysis, expressed as an opinion of credit quality by assignment of an NAIC Designation shall be further expanded into NAIC Designation Categories as, and for the purposes, discussed in this Manual.~~

~~**NOTE**: See "Production of NAIC Designations" in Part Two.~~

~~**Other Non-Payment Risk in Securities**~~

~~39. The result of the SVO's analysis of securities for other non-payment risk is expressed by the assignment of an NAIC Designation Subscript S and the application of the notching procedures described below.~~

~~**NOTE**: See "NAIC Designation Subscript S" and "SVO Notching Guidelines" in Part Two.~~

…

NAIC DESIGNATIONS

~~Definitions~~ Use and Purposes of NAIC Designations

88. **NAIC Designations** are proprietary symbols of the NAIC. The SVO, the SSG and, under certain circumstances, insurers, 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,~~ or gradations of credit quality ~~and credit risk~~ identified by the **NAIC 1** through **NAIC 6** symbols, except when accompanied by the NAIC Designation Subscript S, denoting Other Non-Payment Risks, further discussed and defined in this Manual.
[Editing note: Moved from Part Two, para. 18]

89. **NAIC Designations** reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default.

90. **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 *[Editing note: Moved from Part Two, para. 18]* and 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. *[Editing note: Moved from Part One, para. 37]* ~~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. 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.~~ *[Editing note: Deleted from Part Two, para. 18]*

91. **NAIC Designations** must also be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) and other NAIC guidance. For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.

92. ~~**NAIC Designation** – Means any one of the gradations of credit quality and credit risk identified by the **NAIC 1** through **NAIC 6** symbols further discussed and defined in this Manual and may reflect notching pursuant to one or both of the notching procedures discussed in this Manual. NAIC Designations are proprietary symbols of the NAIC to be used by the SVO and SSG or under certain circumstances by an insurer to denote a category or band of credit risk.~~

[Editing note: Originally in Part One, para. 88]

~~NAIC DESIGNATIONS~~ RISKS ADDRESSED BY NAIC DESIGNATIONS

[Editing note: moved from Part One, para. 37]

93. The NAIC's ~~SVO's~~ analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation and Designation Category that ~~is~~ may be notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations and Designation Categories, 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, described below, except when accompanied by the NAIC Designation S~~s~~ubscript S, denoting Other Non-Payment Risks ~~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. NAIC Designations may be adjusted to reflect Other Non-Payment Risks, as described in this manual.

- An NAIC Designation shall reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default. It will also reflect consideration to potential "tail risks" (e.g. the probability that a security's payment default will be more than three standard deviations from the mean is greater than what is shown by a normal distribution).

- NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk, though these other risks may be reflected in Other Non-Payment Risks, as described in this manual.

NAIC DESIGNATION SUBSCRIPT S (OTHER NON-PAYMENT RISK)

NAIC Designation Subscript S

94. An objective of the VOS/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is required to identify securities that contain such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer, so this can be reflected in the NAIC Designation assigned to the security through the application of the notching process.
[Editing note: Moved from Part One, para. 90]

~~NOTE: See "NAIC Designation Subscript S" in Part Two.~~

Description of Other Non-Payment Risk

95. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.
[Editing note: Moved from Part Two, para. 33]

96. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.
[Editing note: Moved from Part Two, para. 34]

97. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a schedules basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).
[Editing note: Moved from Part Two, para. 35]

98. Using the broad concepts identified above, non-payment risk may be present when:

- A reporting insurance company takes on a participatory risk in the transaction;

  Illustration – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.

- The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;

  Illustration – A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.

  Illustration – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity dates (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.

  [Editing note: Moved from Part Two, para. 36]

- The governing agreements permit irregular or conditional payments that are incompatible with the notion of an issuer making periodic scheduled payments of interest and repaying principal in full to the insurer on a date certain;

  Illustration – A Principal Protected Security, as defined in Part Three of this Manual.

  Illustration – A security with no contractual events of payment default.

  Illustration - A security with contractual terms that have the potential to result in payment of contractually promised interest and/or return of principal in an amount less than the original investment.

Illustration – A security with an interest payment deferral feature that does not capitalize interest into principal or permits interest deferral for greater than twenty-four months or past legal maturity.

- ~~Agrees to an exposure that has the potential to result in a significant delay in payment of contractually promised interest and/or a return of principal in an amount less than the original investment.~~
  [Editing note: Originally in Part Two, para. 37]

Directive to the SVO to Assign the Subscript S Symbol

99. The VOS/TF expressly assigns to the SVO the responsibility for assessing Other Non-Payment Risk and the authority to notch NAIC Designations and assign the Subscript S Symbol, accordingly. It does so in recognition that credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes. The VOS/TF may periodically request the SVO report to it on information the SVO gathers from its review of Subscript S securities, including, for example, volume of such securities and the types of other non-payment risks.

Meaning of the Subscript S Symbol

100. An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows: **NAIC 2S**.
[Editing note: Moved from Part Two, para. 38]

101. The SVO shall assess securities for other non-payment risk:

- Routinely, for any security or financial product filed with the SVO.
- As part of the analysis of a security or financial product submitted to the SVO under the RTAS – Emerging Investment Vehicle process discussed in of this Manual.
- When requested to do so by any state insurance regulator acting pursuant to this Manual, and:
- When requested by the VOS/TF; or
- In support of any other NAIC group engaged in the analysis of investment risks in new securities.

~~**NOTE**: See "NAIC Designation Subscript S" in Part One.~~

[Editing note: Moved from Part Two, para. 39]

~~**Other Non-Payment Risk in Securities**~~

~~96. The result of the SVO's analysis of securities for other non-payment risk is expressed by the assignment of an NAIC Designation Subscript S and the application of the notching procedures described below in this Manual.~~

[Editing note: Originally in Part One, para. 39]

~~NOTE: See "NAIC Designation Subscript S" and "SVO Notching Guidelines" in Part Two.~~

APPLICATION OF NAIC DESIGNATIONS

102. **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 Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 19]

103. **NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An **NAIC 2** obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 20]

104. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 21]

105. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 22]

106. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 23]

107. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.
[Editing note: Moved from Part Two, para. 24]

NOTE: See ~~"NAIC Designations,"~~ "Prohibition on Use of NAIC Designation in a Covenant" and "Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force" in Part One; ~~"NAIC Designation Categories" below~~; and "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three.

APPLICATION OF NAIC DESIGNATION CATEGORIES

108. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories~~, as described and defined in this Manual~~.
[Editing note: Moved from Part Two, para. 25]

109. **NAIC Designation Category** – Means and refers to 20 more granular delineations of credit risk in the **NAIC 1** through **NAIC 6** credit risk scale used by the VOS/TF to relate credit risk in insurer-owned securities to a risk-based capital factor assigned by the NAIC Capital Adequacy (E) Task Force. Each delineation of credit risk is represented by a letter (a Modifier) which modifies the NAIC Designation grade to indicate a more granular measure of credit risk within the NAIC Designation grade. The more granular delineations of credit risk are distributed as follows: 7 for the **NAIC 1** Designation grade indicated by the letters A through G; 3 delineations each for each of the NAIC Designation grades **NAIC 2**, **NAIC 3**, **NAIC 4** and **NAIC 5** indicated by the letters A, B and C and 1 delineation for NAIC Designation grade **NAIC 6**. The NAIC Designation Category framework is shown in this Manual. All Modifiers roll up into the respective NAIC Designation grade as they are a subset of them.

~~NOTE: See "Production of NAIC Designations" in Part Two.~~
[Editing Note: Moved from Part One, para. 89.]

110. **NAIC Designation Categories** are a subset of **NAIC Designations** and are used by the VOS/TF to link the NAIC risk-based-capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
1		A		1.A
1		B		1.B
1		C		1.C
1		D		1.D
1		E		1.E
1		F		1.F
1		G		1.G
2		A		2.A
2		B		2.B
2		C		2.C
3		A		3.A
3		B		3.B
3		C		3.C
4		A		4.A
4		B		4.B
4		C		4.C
5		A		5.A
5		B		5.B

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
5		C		5.C
6				6

[Editing note: Moved from Part Two, para. 26]

111. NAIC Designations and Designation Categories may be adjusted in accordance with the notching procedures described in this Manual below so that an NAIC Designation and Designation Category for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations and Designation Categories may also be adjusted by notching to reflect the existence of O~~o~~ther N~~n~~on-P~~p~~ayment R~~r~~isks in the specific security in accordance with the procedures described in this Manual associated with NAIC Designations Subscript S.
[Editing note: Moved from Part Two, para. 18]

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION

112. An insurance company that self-assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.
[Editing note: Moved from Part Two, para. 27]

113. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met. *[Editing note: Moved from Part Two, para. 28]*

114. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation. *[Editing note: Moved from Part Two, para. 29]*

115. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.
[Editing note: Moved from Part Two, para. 30]

116. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation. *[Editing note: Moved from Part Two, para. 31]*

117. Securities that are residual tranches or interests, as defined in *SSAP 43R – Loan Backed and Structured Securities*, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.
[Editing note: Moved from Part Two, para. 32]

~~**NOTE REGARDING RESIDUAL TRANCHES OR INTERESTS**: For 2021 year-end reporting only, residual tranches or interests previously reported on Schedule D-1: Long-Term Bonds shall be permitted to be reported on Schedule D-1 with an NAIC 6* Designation, however an NAIC 5GI is not permitted.~~

NOTE: The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.
[Editing note: Moved from Part Two, para. 32]

NAIC General Interrogatory

118. **NAIC 5GI** and NAIC Designation Category **NAIC 5.B GI** is assigned by an insurance company to certain obligations that meet all of the following criteria:

- Documentation necessary to permit a full credit analysis of a security by the SVO does not exist or an NAIC CRP credit rating for an FE or PL security is not available.
- The issuer or obligor is current on all contracted interest and principal payments.
- The insurer has an actual expectation of ultimate payment of all contracted interest and principal.

[Editing note: Moved from Part One, para. 91]

NAIC PLGI

119. Effective July 1, 2018, insurance companies shall be responsible for providing the SVO copies of private rating letters for PL securities, where applicable, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs. For PL Securities issued prior to January 1, 2018, if an insurance company cannot provide a copy of the rating letter to the SVO due to confidentiality concerns and the rating is not included in a CRP credit rating feed (or other form of direct delivery from the NAIC CRP), the insurer shall report such securities on such securities' General Interrogatory to be developed for this purpose (i.e., a PLGI security). *[Editing note: Moved from Part One, para. 92]*

Monitoring of SVO-Designated Securities

120. The SVO shall monitor, on an ongoing basis through the information provided by insurers as required by the Material Credit Events Filing described in this Manual, improvements and deterioration of credit quality of securities that are not filing exempt. *[Editing note: Moved from Part One, para. 93]*

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

~~PRODUCTION OF NAIC DESIGNATIONS~~ [EDITING NOTE: MOVED TO PART ONE "NAIC DESIGNATIONS".]

~~**NAIC DESIGNATIONS**~~

~~18. 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. 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. 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.~~

~~19. **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 Regulation Standards and Accreditation Program.~~

~~20. **NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An **NAIC 2** obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

~~21. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

~~22. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

~~23. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

~~24. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

~~**NOTE**: See "NAIC Designations," "Prohibition on Use of NAIC Designation in a Covenant" and "Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force" in Part One; "NAIC Designation Categories" below; and "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three.~~

~~NAIC DESIGNATION CATEGORIES~~

~~25. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories, as described and defined in this Manual.~~

~~26. NAIC Designation Categories are a subset of NAIC Designations and are used by the VOS/TF to link the NAIC risk-based capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.~~

~~NAIC Designation~~	~~+~~	~~NAIC Designation Modifier~~	~~=~~	~~NAIC Designation Category~~
~~1~~		~~A~~		~~1.A~~
~~1~~		~~B~~		~~1.B~~
~~1~~		~~C~~		~~1.C~~
~~1~~		~~D~~		~~1.D~~
~~1~~		~~E~~		~~1.E~~
~~1~~		~~F~~		~~1.F~~
~~1~~		~~G~~		~~1.G~~
~~2~~		~~A~~		~~2.A~~
~~2~~		~~B~~		~~2.B~~
~~2~~		~~C~~		~~2.C~~
~~3~~		~~A~~		~~3.A~~
~~3~~		~~B~~		~~3.B~~
~~3~~		~~C~~		~~3.C~~
~~4~~		~~A~~		~~4.A~~
~~4~~		~~B~~		~~4.B~~
~~4~~		~~C~~		~~4.C~~
~~5~~		~~A~~		~~5.A~~
~~5~~		~~B~~		~~5.B~~
~~5~~		~~C~~		~~5.C~~
~~6~~				~~6~~

~~NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION~~

~~27. An insurance company that self-assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.~~

~~28. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met.~~

~~29. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation.~~

~~30. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.~~

~~31. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.~~

~~32. Securities that are residual tranches or interests, as defined in *SSAP 43R – Loan Backed and Structured Securities*, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.~~

~~**NOTE REGARDING RESIDUAL TRANCHES OR INTERESTS**: For 2021 year-end reporting only, residual tranches or interests previously reported on Schedule D-1: Long-Term Bonds shall be permitted to be reported on Schedule D-1 with an NAIC 6* Designation, however an NAIC 5GI is not permitted.~~

~~**NOTE**: The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.~~

~~NAIC DESIGNATION SUBSCRIPT S~~

~~Description of Other Non-Payment Risk~~

~~33. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.~~

~~34. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.~~

~~35. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a schedules basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).~~

~~36. Using the broad concepts identified above, non-payment risk may be present when:~~

- ~~A reporting insurance company takes on a participatory risk in the transaction;~~

  ~~*Illustration – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.*~~

- ~~The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;~~

  ~~*Illustration – A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.*~~

  ~~*Illustration – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity dates (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.*~~

~~37. Agrees to an exposure that has the potential to result in a significant delay in payment of contractually promised interest and/or a return of principal in an amount less than the original investment.~~

~~Meaning of the Subscript S Symbol~~

~~38. An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows: **NAIC 2S**.~~

~~39. The SVO shall assess securities for other non-payment risk:~~

- ~~Routinely, for any security or financial product filed with the SVO.~~
- ~~As part of the analysis of a security or financial product submitted to the SVO under the RTAS – Emerging Investment Vehicle process discussed in of this Manual.~~
- ~~When requested to do so by any state insurance regulator acting pursuant to this Manual, and:~~

  ~~*When requested by the VOS/TF; or*~~

  ~~*In support of any other NAIC group engaged in the analysis of investment risks in new securities.*~~

~~**NOTE**: See "NAIC Designation Subscript S" in Part One.~~

(CLEAN VERSION WITHOUT CHANGES DISPLAYED WITH ADDITIONS HIGHLIGHTED)

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

NAIC DESIGNATIONS

Use and Purposes of NAIC Designations

88. **NAIC Designations** are proprietary symbols of the NAIC. The SVO, the SSG and, under certain circumstances, insurers, 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 gradations of credit quality identified by the **NAIC 1** through **NAIC 6** symbols, except when accompanied by the NAIC Designation Subscript S, denoting Other Non-Payment Risks, further discussed and defined in this Manual.

89. **NAIC Designations** reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default.

90. **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 and 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.

91. **NAIC Designations** must also be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) and other NAIC guidance. For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.

RISKS ADDRESSED BY NAIC DESIGNATIONS

92. The NAIC's ~~SVO's~~ analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation and Designation Category that is ~~may be~~ notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations and Designation Categories, 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, described below, except when accompanied by the NAIC Designation Subscript S, denoting Other Non-Payment Risks.

- 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. NAIC Designations may be adjusted to reflect Other Non-Payment Risks, as described in this manual.
- An NAIC Designation shall reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default. It will also reflect consideration to potential "tail risks" (e.g. the probability that a security's payment default will be more than three standard deviations from the mean is greater than what is shown by a normal distribution).
- NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk, though these other risks may be reflected in Other Non-Payment Risks, as described in this manual.

NAIC DESIGNATION SUBSCRIPT S (OTHER NON-PAYMENT RISK)

NAIC Designation Subscript S

93. An objective of the VOS/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is required to identify securities that contain such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer, so this can be reflected in the NAIC Designation assigned to the security through the application of the notching process.

Description of Other Non-Payment Risk

94. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.

95. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.

96. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a schedules basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).

97. Using the broad concepts identified above, non-payment risk may be present when:

   - A reporting insurance company takes on a participatory risk in the transaction;

     Illustration – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.

   - The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;

     Illustration – A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.

     Illustration – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity dates (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.

- The governing agreements permit irregular or conditional payments that are incompatible with the notion of an issuer making periodic scheduled payments of interest and repaying principal in full to the insurer on a date certain;

  Illustration – A Principal Protected Security, as defined in Part Three of this Manual.

  Illustration – A security with no contractual events of payment default.

  Illustration - A security with contractual terms that have the potential to result in payment of contractually promised interest and/or return of principal in an amount less than the original investment.

  Illustration – A security with an interest payment deferral feature that does not capitalize interest into principal or permits interest deferral for greater than twenty-four months or past legal maturity.

Directive to the SVO to Assign the Subscript S Symbol

98. The VOS/TF expressly assigns to the SVO the responsibility for assessing Other Non-Payment Risk and the authority to notch NAIC Designations and assign the Subscript S Symbol, accordingly. It does so in recognition that credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes. The VOS/TF may periodically request the SVO report to it on information the SVO gathers from its review of Subscript S securities, including, for example, volume of such securities and the types of other non-payment risks.

Meaning of the Subscript S Symbol

99. An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows: **NAIC 2S**.

100. The SVO shall assess securities for other non-payment risk:

- Routinely, for any security or financial product filed with the SVO.
- As part of the analysis of a security or financial product submitted to the SVO under the RTAS – Emerging Investment Vehicle process discussed in of this Manual.
- When requested to do so by any state insurance regulator acting pursuant to this Manual, and:
- When requested by the VOS/TF; or

- In support of any other NAIC group engaged in the analysis of investment risks in new securities.

APPLICATION OF NAIC DESIGNATIONS

101. **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 Regulation Standards and Accreditation Program.

102. **NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An **NAIC 2** obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

103. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

104. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

105. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

106. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.

NOTE: See "Prohibition on Use of NAIC Designation in a Covenant" and "Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force" in Part One; and "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three.

APPLICATION OF NAIC DESIGNATION CATEGORIES

107. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories.

108. **NAIC Designation Category** – Means and refers to 20 more granular delineations of credit risk in the **NAIC 1** through **NAIC 6** credit risk scale used by the VOS/TF to relate credit risk in insurer-owned securities to a risk-based capital factor assigned by the NAIC Capital Adequacy (E) Task Force. Each delineation of credit risk is represented by a letter (a Modifier) which modifies the NAIC Designation grade to indicate a more granular measure of credit risk within the NAIC Designation grade. The more granular delineations of credit risk are distributed as follows: 7 for the **NAIC 1** Designation grade indicated by the letters A through G; 3 delineations each for each of the NAIC Designation grades **NAIC 2**, **NAIC 3**, **NAIC 4** and **NAIC 5** indicated by the letters A, B and C and 1 delineation for NAIC Designation grade **NAIC 6**. The NAIC Designation Category framework is shown in this Manual. All Modifiers roll up into the respective NAIC Designation grade as they are a subset of them.

109. **NAIC Designation Categories** are a subset of **NAIC Designations** and are used by the VOS/TF to link the NAIC risk-based-capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
1		A		1.A
1		B		1.B
1		C		1.C
1		D		1.D
1		E		1.E
1		F		1.F
1		G		1.G
2		A		2.A
2		B		2.B
2		C		2.C
3		A		3.A
3		B		3.B
3		C		3.C
4		A		4.A
4		B		4.B
4		C		4.C
5		A		5.A
5		B		5.B
5		C		5.C
6				6

110. NAIC Designations and Designation Categories may be adjusted in accordance with the notching procedures described in this Manual below so that an NAIC Designation and Designation Category for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations and Designation Categories may also be adjusted by notching to reflect the existence of Other Non-Payment Risks in the specific security in accordance with the procedures described in this Manual associated with NAIC Designations Subscript S.

NAIC Designations Related to Special Reporting Instruction

111. An insurance company that self-assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.

112. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met.

113. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation.

114. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.

115. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.

116. Securities that are residual tranches or interests, as defined in *SSAP 43R – Loan Backed and Structured Securities*, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.

NOTE: The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.

NAIC General Interrogatory

117. **NAIC 5GI** and NAIC Designation Category **NAIC 5.B GI** is assigned by an insurance company to certain obligations that meet all of the following criteria:

- Documentation necessary to permit a full credit analysis of a security by the SVO does not exist or an NAIC CRP credit rating for an FE or PL security is not available.
- The issuer or obligor is current on all contracted interest and principal payments.
- The insurer has an actual expectation of ultimate payment of all contracted interest and principal.

NAIC PLGI

118. Effective July 1, 2018, insurance companies shall be responsible for providing the SVO copies of private rating letters for PL securities, where applicable, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs. For PL Securities issued prior to January 1, 2018, if an insurance company cannot provide a copy of the rating letter to the SVO due to confidentiality concerns and the rating is not included in a CRP credit rating feed (or other form of direct delivery from the NAIC CRP), the insurer shall report such securities on such securities' General Interrogatory to be developed for this purpose (i.e., a PLGI security).

Monitoring of SVO-Designated Securities

119. The SVO shall monitor, on an ongoing basis through the information provided by insurers as required by the Material Credit Events Filing described in this Manual, improvements and deterioration of credit quality of securities that are not filing exempt.

Mike Monahan
Senior Director, Accounting Policy
T: 202-624-2324
mikemonahan@acli.com

June 29, 2023

Ms. Carrie Mears, Chair
Valuation of Securities Task Force
National Association of Insurance Commissioners (NAIC)
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "P&P Manual" or "the Manual") to Update the Definition of an NAIC Designation in Parts One and Two of the P&P Manual

Dear Ms. Mears:

The undersigned (ACLI, PPIA, SFA, and NASVA) appreciate the opportunity to comment on the exposure referred to above that was released for comment by the Valuation of Securities Task Force (VOSTF) on May 15, 2023. We generally like to provide constructive comments on VOSTF exposures and provide support wherever possible. However, the undersigned are confused on the intent, scope and potential impact of this exposure, as it relates to the Definition of an NAIC Designation and Subscript S Non-Payment Risk. The commingling of these two issues, without any significant, robust documented rationale or transparency of the potential impact, leaves the undersigned guessing as to the impact and precludes us from providing more targeted comments.

The undersigned are concerned about the proposed expansion in scope of Securities Valuation Office (SVO) responsibilities, without transparency as to the rationale and impact of the specific proposed changes, the specific processes that will be impacted related to the proposed changes, and the issues surrounding the differentiation between individual security risk and portfolio risk. This view is substantiated by the conclusions of an extensive study commissioned by the VOSTF, following a non-transparent SVO initiative related to trust preferred securities. The capital market disruption that followed the trust preferred securities actions resulted in a congressional inquiry, and VOSTF commissioned a study from a subgroup of the Investment Analysis Working Group that among other things:

- Was part of the NAIC's transparency initiative, which was necessary to minimize future problems, and
- Focused on examining individual security risks versus portfolio risks

We support NAIC initiatives to address market innovation but believe transparency is important and historical lessons learned should not be forgotten. The report is included as Attachment A, and we will refer to both transparency and individual security risk throughout this letter.

That study concluded that credit risk is separate and distinct from multiple other identified risks, including event, liquidity, call, extension, deferral, and currency risks. In its Exhibit Three it also describes how these non-credit risks were addressed in the regulatory framework. Among those on the working group expert panel were regulators, NAIC staff and accounting, actuarial and investment professionals. Insurance industry trade associations were not included.

We understand weekly meetings (some day-long) were held beginning in January 2008 and continued at least through May. The final report was submitted in August 2008.

Ultimately, the working group recommended improvements in asset-specific disclosures and a regular reassessment of RBC factors by the Capital Adequacy Task Force (CATF), but the working group did not recommend that the scope of risks assessed as part of an NAIC designations be expanded, because many of the other defined risks were already captured in some way within the C-1 Risk Based Capital (RBC) risk framework and not related to credit risk. The findings of the study were consistent with the current language in Part One, Item 27 of the Practices & Procedures (P&P) Manual that specifically states: "NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk." This exposure seems to be a reversal of prior NAIC policy and recommendations culminating from a very thorough analysis performed by the working group.

Definition of an NAIC Designation

In addition to Subscript S Non-Payment Risk, which we will address later in our letter, the changes to the Definition of an NAIC Designation include several changes that we believe need further and transparent review. These changes include the following:

> *89. NAIC Designations reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default.*
>
> *91. NAIC Designations must also be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) and other NAIC guidance. For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.*
>
> *92. An NAIC Designation shall reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default. It will also reflect consideration to potential "tail risks" (e.g., the probability that a security's payment default will be more than three standard deviations from the mean in greater than what is shown in a normal distribution).*

Since the exposure gives no compelling rationale as to why these changes have been made, nor to their potential impact, the undersigned request additional transparency as to their impact.

Included in paragraph 89 is the statement that NAIC Designations "reflect the timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default." The undersigned have often questioned why the SVO's and Structured Securities

Group's (SSG) designation methodology considers only the likelihood of payment default, ignoring expected recovery should a security default in payment (i.e., ignoring loss given default). Industry has spoken with multiple rating agencies, all of whom take into account expected recoveries following payment default for specific types of securities (first mortgage bonds, equipment trust certificates, enhanced equipment trust certificates and speculative grade debt, to name a few) as well as considering where debt resides within an issuer's capital stack. Likewise, bank lending also takes expected recoveries into account, with most banks strongly preferring to lend on a secured basis, recognizing the importance of collateral in reducing the overall risk position of a loan. The undersigned understand that RBC charges were initially developed using a Moody's framework, and Moody's considers expected losses, including loss given default analysis—not just a probability of default framework. The report in Attachment A highlights that Moody's and S&P factor in loss given default and recoveries as well. Therefore, the undersigned would like to understand whether basing NAIC Designations/ratings on likelihood of payment default alone (giving no consideration to potential recoveries) is incongruous with how NAIC RBC charges were developed. We propose that this matter to be formally referred to the Capital Adequacy Task Force. Specifically, CATF should assess whether the proposed language is in-line with how the NAIC's risk-based capital charges were developed, and whether it changes the meaning of an NAIC designation in a way that is incongruous with CATF's intent.

The following is from paragraph 91, "*For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.*" While the undersigned believe this phrase is rather innocuous, we believe it is appropriate to formally refer this change to CATF as well. Presumably, an NAIC designation's primary purpose (not just in "many cases") is to serve as the basis for determining the appropriate risk-based capital charge. CATF should ensure that either the reference to SFRS and "Other NAIC guidance" do not change the intent of CATF for risk-based capital and/or whether "Other NAIC guidance" needs to be explicitly and transparently defined so interpretation is not in question.

Similarly, paragraph 92 includes a new concept whereby designations should consider potential "tail risks" (e.g., the probability that a security's payment default will be more than three standard deviations from the mean is greater than what is shown by a normal distribution). This is a new concept for the P&P Manual, and limited context has been provided, leaving industry to wonder how this concept would be applied in practice by NAIC staff.

1) Does it mean that NAIC staff would assign a designation, based on expected performance under tail risk outcomes, or that staff would assign a designation based on the most likely outcomes, yet somehow give consideration to tail risk events? If the latter, how would that work?
2) If a security is rated by a Credit Rating Provider (CRP), and NAIC staff does not believe that the CRP is giving sufficient consideration to tail risk outcomes (or they disagree on what the relevant tail risk scenarios are) will staff notch that CRP rating for tail risk?
3) How does analysis of tail risk differ between structured securities and issuer obligations?
4) Is the proposal for tail risk analysis as drafted consistent with how RBC factors were determined?

The addition of tail risk analysis into an NAIC Definition raises several issues that the undersigned feel must be clearly addressed.

The undersigned again propose that this matter be formally referred to CATF, to consider whether this is in line with how the NAIC's risk-based capital charges were developed, whether it changes the meaning of an NAIC designation in a way that is incongruous with CATF's intent, and/or whether it is a departure from definitions provided for agency credit ratings, who make no such references in their definitions. Ultimately, if this concept is adopted, its definition and impact should be very explicitly and transparently documented. Insurers need to understand in practice how tail risk would be evaluated—both for structured securities and for issuer obligations.

Lastly, many references to Subscript S and liquidity have been referred to within the newly proposed Definition of an NAIC Designation. Subscript S warrants a significant and separate section within our letter.

Subscript S Non-Payment Risk

Proposed Change in Scope Regarding Subscript S Authority

The exposure was presented as a technical change intended to simplify the P&P Manual. However, the undersigned believe that combining the NAIC Designation Subscript S definition in Part Two of the P&P Manual with the definition of an NAIC Designation in Part One, as drafted, effectively expands the scope of the SVO's and the SSG's authority. Part Two of the current version of the P&P Manual clearly limits the SVO's ability to assess for Subscript S risks to transactions where the SVO assigns a Designation or where the VOSTF or a regulator request that the SVO assess Subscript S risk for a particular transaction. The undersigned believe that the P&P Manual, as currently constructed, does not allow the SVO to notch ratings assigned by CRPs. This view is further supported by the fact that there are no Blanks administrative symbols in Schedule D for an NAIC Designation that combine both the "FE" and the "S" subscripts. Administrative symbols exist for "FE" and for "S" individually, but not for "FE" and "S" in combination.

The undersigned believe that the exposure could be interpreted as granting the SVO/SSG authority, not only to identify Subscript S risks, but to notch NAIC Designations accordingly—both those assigned directly by the SVO and those assigned by CRPs. The undersigned specifically reference two parts of the exposure that lead us to believe this is the practical outcome:

1) The bullet point in Part One, Item 93 was specifically modified to add the italicized phrase highlighted in red: "NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk, *though these other risks may be reflected in Other Non-Payment Risks, as described in this manual."* The additional reference to Other Non-Payment Risks specifically modifies the scope of an NAIC designation to allow for consideration of such risks.

2) Item 99, entitled "Directive to the SVO to Assign the Subscript S Symbol" was added to the Manual as part of the exposure. This provision states that: *"The VOS/TF expressly assigns to the SVO the responsibility for assessing Other Non-Payment Risk and the authority to notch NAIC Designations and assign the Subscript S Symbol, accordingly. It does so in recognition that credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes. The VOS/TF may periodically request the SVO report to it on information the SVO gathers from its review of Subscript S securities, including, for example, volume of such securities and the types of other non-payment risks."* This additional language would effectively delegate authority for assessing Other Non-

Payment Risk to the SVO and allow the SVO to notch CRP ratings for Other Non-Payment Risk if it deems appropriate. This is a departure from past practice.

The result of these two additions could potentially allow the SVO/SSG to notch securities for Other Non-Payment Risks with limited oversight from the VOSTF or from other regulatory bodies. Furthermore, the exposure is unclear under what circumstances, and to what degree, the SVO/SSG could notch securities for Other Non-payment Risks, which raises multiple questions:

1) Would notching be applied only to non-filing exempt securities?
2) If no, would notching be applied to both privately rated and publicly rated filing exempt securities?
3) How would the SVO/SSG identify and assess these risk characteristics for both privately and publicly rated filing exempt securities? For example, would all 40-year bonds (a proposed type of Subscript S security) need to be filed "as if" they were not filing exempt, so the SVO/SSG could assess and notch for Subscript S risk? (If so, this would essentially make these securities non-filing exempt.)
4) To what degree might the SVO/SSG notch, and under what circumstances might they choose to do so? Would it be a one-notch impact, a two-notch impact, or more?
5) Would the notching methodology be documented in a methodical and transparent way?

We have had multiple conversations with regulators and SVO staff on this issue over the past 12 – 18 months, and we still do not know the answers to the above questions. We have never received straightforward, transparent answers in our discussions, nor is it clear in this latest written exposure. We have yet to understand exactly what the exposure intends to accomplish and why it is necessary.

<u>Fundamental Concerns with Subscript S Proposal</u>

We understand from discussion with both the SVO and Regulators, for example, that interest deferral may not relate to individual security risk but may be information that individual regulators would like to have. For example, individual regulators may want to ensure that such securities are factoring in liquidity risk (e.g., if there is a significant concentration of securities with deferral features) in asset adequacy testing (AAT) for an individual company. Other times, Subscript S may represent non-payment risk as defined, and we will discuss this in more detail below.

For risks that are not individual security risks, but Regulators have a desire/need for further information (e.g., deferral risk for better understanding how utilized in AAT), the appropriate solution would be to bifurcate the Subscript S definition into two categories. Subscript S tags would represent Non-Payment Risk, while a new tag could be created (call it Subscript T, for example) to reflect securities with other portfolio risks, where the SVO does not alter its designation, as it is not an individual credit risk, but where additional disclosure is needed for Regulators at the individual company level. The undersigned are very open to providing more information on portfolio risks such as PIK interest, deferrals, prepayment risk, 40-year maturities, perpetual bonds, etc., and we are willing to work with Regulators and NAIC staff to determine the best way to provide such disclosure. We just do not believe that these risks represent credit risks for which the SVO/SSG should notch securities (or deem the securities non-filing exempt, as the exposure seems to suggest.)

As noted in our previous letter dated September 12, 2022, the undersigned highlight which of the Subscript S risks identified we believe to be individual security risks versus portfolio risks. Please see the

7 illustrations within paragraph 97 of the exposure and the illustrations below that highlight responses from our previous letter. For a more fulsome response see Attachment B to this letter.

#	Illustration	Represents Non-Payment Risk (Y/N?)	Additional Comments
1	Dollar-denominated obligation in non-U.S. currency (with no exchange rate)	Yes	See original response letter for proposed edits to ensure this language is not meant to construe that all foreign denominated bonds (i.e. not a dollar denominated obligation) have non-payment risk.
2	Perpetual debt that can miss payments w/ no requirement to be repaid	Yes	But this is duplicative of both 3a and 5 below, and is better captured in 5 below more holistically.
3a	Perpetual bonds	No	We note the Working Group report in Exhibit 2 states that risk of permanence is not an individual security risk but is an example of extension risk (exhibit 2). A quick query of Bloomberg shows there are approximately $200 billion of investment grade perpetual bonds, and we would like to understand the ratinale for filing these with the SVO for designations.
3b	40+ year maturities	No	But may be important for regulators to understand at a portfolio level where disclosure is desired.
4	Principal Protected Securities	Yes (?)	Note: These are already non-filing exempt and not schedule D bonds. Are these really non-payment risk or just not filing exempt?
5	Bonds without contractual events of payment default	Yes	Recommend additional clarity be provided, as the descriptor is one sentence with nine words. The undersigned are hard-pressed to find any examples of such securities within the capital markets.
6	A security that results in less payment than the orginal investment.	Yes	Important clarification language should be added so it would not capture bonds issued at a premium--see original response letter
7a	Security with PIK or deferred interest that doesn't capitalize or otherwise accrue	Yes	
7b	Security with PIK or deferred interest than can just be defered but otherwise capitalizes or accrues.	No	This is portfolio risk. The clear intent of the VOSTF commissioned report was to separate PIK interest and other payment deferral risks from credit risk and the NAIC desigation process. This is consistent with the current drafting in the P&P Manual. Further disclosure may be merited for AAT to understand cash flow deferral risks wholistically at a portfolio level.

Conclusion

The undersigned understand Regulators' interest in clarifying the definition of what an NAIC Designation represents - and we agree. However, we believe transparency surrounding the meaning and impact of any proposed changes should be afforded to industry and all interested parties. As such, the undersigned request a formal referral to CATF to elicit such an understanding. The undersigned also understand Regulators' interest in Other Non-Payment Risks and portfolio risks, and we are willing to work collaboratively with NAIC staff and regulators to help distinguish between individual security risks vs. portfolio risks. We are very willing to provide additional blanks fields and/or footnotes, if desired by Regulators, to identify these risks and provide sufficient qualitative information to help Regulators understand implications for insurance portfolios (e.g., portfolio risks such as PIK interest, deferrals, prepayment risk, 40-year maturities, perpetual bonds, etc.). However, this is a long running issue, and we still do not have answers to basic questions. We again ask for complete transparency to our questions related to Subscript S.

The undersigned believe the separation of Subscript S between part one and part two of the P&P Manual was deliberate. This makes it all the more important to provide robust and transparent answers to the questions we lay out, so that all parties understand any new authority bestowed to the SVO. For example, if all 40 - year bonds (which we do not believe represent non-payment risk) must now be filed with the SVO for NAIC Designations, then this is a significant change that should be transparent. (These bonds are not currently filed with the SVO.) Ultimately, the undersigned believe this exposure conflates portfolio risks and other non-payment risks with credit risk.

For securities that the undersigned believe truly represent non-payment risk (see table above), we could support those securities being filed with the SVO for a NAIC designation, similar to PPS. For the remaining types of securities listed in the chart above, which the undersigned do not believe represent individual security non-payment risk, but instead represent portfolio risk (e.g., PIK interest, deferral and extension risk, or 40-year bonds, perpetual bonds, etc.), we support disclosure so individual regulators can use as needed (e.g., in assessing if reflected in AAT). This would eliminate the concept of notching altogether – a concept for which there seems to be much confusion. Developing a common understanding of these issues amongst Regulators, the SVO, and all interested parties, needs to happen via a robust and transparent process. The undersigned stand ready to assist in this matter, and we welcome continued dialogue and questions.

Sincerely,

Mike Monahan	Tracey Lindsey	Michael Bright	John Petchler
ACLI	NASVA	SFA	on behalf of PPiA Board of Directors

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

American Council of Life Insurers | 101 Constitution Ave, NW, Suite 700 | Washington, DC 20001-2133

The American Council of Life Insurers ("ACLI") is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long- term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States. For more information, visit www.acli.com.

The Private Placement Investors Association ("PPiA") is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PPiA serves 66 member companies and works with regulators, NASVA, the ACLI, the American College of Investment Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace. For more information, visit www.usppia.com.

The National Association of Securities Valuation Analysts ("NASVA") is an association of insurance company representatives who interact with the NAIC Securities Valuation Office ("SVO") to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes.

The Structured Finance Association is the leading securitization trade association representing over 370 member companies from all sectors of the securitization market. Our core mission is to support a robust and liquid securitization market and help its members and public policymakers grow credit availability and the real economy in a responsible manner. SFA provides an inclusive forum for securitization professionals to collaborate and, as industry leaders, drive necessary changes, advocate for the securitization community, share best practices and innovative ideas, and offers professional development for industry members through conferences and other programs. For more information, visit www.structuredfinance.org.

National Association of Insurance Commissioners

Securities Valuation Office

Attachment -1
Report of the Risk Subgroup of the IAWG

Memorandum

To: Invested Asset Working Group
From: Risk Subgroup of the Invested Asset Working Group
Date: August 26, 2008
Subject: Review of Investment Risks

This is the report of the Risk Subgroup of the NAIC Invested Asset Working Group (IAWG). The Subgroup was formed to evaluate all investment risks to determine which risks are individual security risks for fixed income securities and to review how those individual security risks are handled in the current NAIC regulatory framework.

The need to undertake the review of investment risks stemmed from the events that followed the hybrid security decisions taken by the NAIC in 2006. The issues were finally resolved by the adoption of the American Academy of Actuaries (AAA) report by the NAIC earlier this year. A full review of all possible investment risks by the IAWG, as part of the NAIC's transparency initiative, was necessary to minimize future problems.

To the extent that the Subgroup observed deficiencies, it would recommend improvements to the IAWG. There were no boundaries on the risks that could be considered as part of the deliberations. The Subgroup consisted of the following regulators and industry representatives:

Max McGee, Prudential, Chair of the Risk Subgroup
Chris Anderson, Anderson Insights
Bob Carcano, NAIC Securities Valuation Office (SVO)
Kevin Fry, Illinois Department of Insurance
Wally Givler, Northwestern Mutual
Trond Odegaard, Allstate
Matti Peltonen, New York Insurance Department
Ruth Sayasith, MetLife
Elaine Weiche, Connecticut Department of Insurance

Aside from the subgroup members listed above, significant input was also provided by Allen Elstein (Connecticut), Jeff Evans (SVO) and Jim Everett (New York).

Although a member of the Subgroup may be associated with a particular company or insurance department, his or her participation in the Subgroup was as an individual, in a professional capacity, rather than representing their company or state. The subgroup was composed of participants with various specialties including: regulatory, financial/capital markets, risk management, actuarial and accounting/reporting.

Risk Subgroup Process

The Subgroup began its work in late January 2008 and conducted weekly conference calls to discuss issues regarding investment risks. The calls did include other regulators from the states represented on the Subgroup, NAIC staff and the SVO. However, the Subgroup members made all decisions regarding the content of the report. All conference calls were documented and the Subgroup members approved minutes of the calls. There was a full and complete discussion of the issues during those calls.

National Association of Insurance Commissioners

Securities Valuation Office

The focus of the Subgroup was fixed income securities only. We began the process by developing a list of all potential investment risks. Our initial list included approximately twenty risks and it swelled to almost thirty as we worked through the process. We used a very deliberate process to discuss each risk on our list. We focused on risks associated with individual securities and not portfolio risks although we did discuss portfolio risks during our deliberations.

We first discussed and arrived at a definition for each risk. Based on that definition, we determined whether a particular risk was an individual security risk. Some risks were discussed and disposed of quickly. Other risks took several calls to reach a conclusion. Ultimately, each risk discussed ended up on one of two lists (Individual Security Risk or Not an Individual Security Risk).

Any discussion of fixed income investment risks should include a discussion of interest rate risk as that risk can fundamentally alter the return of a fixed income instrument. Although interest rate risk was determined not to be an individual security risk but rather a systematic risk, we did discuss it in some detail.

Whenever possible, we considered existing definitions for the risks identified rather than creating new definitions. The definitions may have been changed slightly to reflect the insurance context. The sources used were the NAIC and the Federal Reserve System Joint subgroup on Financial Issues from June 2003 and textbooks such as The Handbook of Fixed Income Securities by Frank Fabozzi.

Discussion of Investment Risks

The Subgroup reviewed twenty-eight potential individual security risks, and through a full and detailed discussion, determined that eight of these risks were present in fixed income securities. The eight risks are credit, event, liquidity, call, extension, deferral, currency and leverage. After discussing all of the risks identified, the Subgroup agreed that there were no material additional individual security risks related to fixed income securities. We also discussed Financial Innovation, which is covered in more detail in Exhibit 4.

There are four additional attachments to this report which supplement our written report. Exhibit 1 provides a summary of the risks that were determined to be individual security risks along with a definition for each risk. Exhibit 2 is a listing of the balance of the risks covered as part of our deliberations, which were determined not to be individual security risks. Exhibit 3 is a grid that describes how each of the eight risks determined to be individual security risks are addressed in the current regulatory framework and recommendations to further improve the regulatory process. Exhibit 4 is Jeff Evans' report on how the ratings of rating agencies reflect loss and recovery given defaults as part of the ratings process.

Credit Risk

Credit risk is the risk of non-performance of contractual payment obligations on bonds, cash equivalents and other invested assets with the characteristics of fixed income instruments. As part of our discussions, we covered the history and development of C-1 (Asset Risk) in the RBC formula and how that relates to credit risk.

The American Academy of Actuaries (AAA) performed a review of default history in the early 1990's in order to develop the AVR and C-1 factors. The AAA utilized the Moody's default statistics as part of that review to classify securities into six rating categories. The study resulted in recommendations on the factors regardless of cause for default.

We also discussed whether the definition should be modified, as it does not explicitly state that there is a risk of downgrades of debt instruments which could lead to greatly reduced market values well before scheduled maturity dates or defaults. It was observed that the C-1 factors contemplated defaults (using a ten-year horizon) and that as an asset is downgraded RBC factors will increase and marking-to-market may even be required. Still, this does not address whether the possibility of downgrades should be stated explicitly in the definition. Ultimately, the Subgroup concluded that the present definition was adequate, however, following the concept that adverse developments for the investor with respect to any risk factor should be expected to result in market price declines for the asset and as such credit risk was not materially different from other risks identified in this regard.

Our conclusion is that C-1 covers the risk of default and is synonymous with credit risk. Credit risk is an individual security risk. Defaults are cyclical and the factors used in C-1 should be reviewed by the NAIC on a periodic basis. We did determine that default experience is reflected in ratings provided by the rating agencies.

We recommend that the Capital Adequacy Task Force review the default studies periodically (at least once every five years or more frequently as circumstances dictate) to determine whether material changes have occurred. Based on that review, a more in-depth study of default experience may be warranted.

Deferral Risk

Deferral risk is the risk of the issuer's right to delay payments of interest or dividends (temporarily or indefinitely) on certain instruments. It was noted that the impact of deferral is already explicitly incorporated in rating agency credit ratings and is also covered as an element of C-1. Deferral risk is required to be disclosed in the bond characteristics codes in Schedule D.

Event Risk

Event risk is the risk of regulatory changes or other external actions or occurrences that are significant and unanticipated, and which impact the value of a security. It includes governmental actions that limit payments from borrowers that are otherwise willing and able to fulfill their obligations. Some examples of event risk are corporate restructuring, takeovers or changes in tax or accounting treatment of an investment as well as natural disasters. Actual or potential corporate restructurings and takeovers, in particular, may have an adverse impact on the holders of fixed-income securities in a number of ways. In general, the impact of an event can be immediate or gradual over time.

Event risk is not a risk that is included in the credit ratings of individual hybrid and other securities, according to papers by the SVO and Standard & Poor's. This is because it is generally believed that it is impossible to factor in predictions of surprise events, such as corporate restructurings and major changes to accounting or regulation, into the ratings of individual securities. Because the factors for AVR and RBC C-1 are intended to set levels for entire portfolios of securities, the impact of defaults caused by unexpected events is actually included in AVR and RBC, even though individual ratings do not reflect event risk. This is because the historical studies that formed the basis for AVR and RBC looked at the occurrences and consequences of all defaults regardless of cause, so if an unexpected event caused a default then that event was included in the calibration of C-1. This is consistent with the understanding that all factors that cause defaults are contemplated by AVR and C-1, and factors that do not cause defaults (such as foreign currency risk) are not included in AVR or C-1 risk factors.

Liquidity Risk

Liquidity risk is defined as the risk that an investor will not be able to buy or sell an asset into the market with the expected bid/ask spread, anticipated price continuity or sufficient depth, thus causing price realization or execution that is unfavorable or nonexistent. The Subgroup agreed that liquidity is both a portfolio level risk as well as an individual security risk. Liquidity risk could also change over time based on the occurrence of certain events that could make the security less liquid.

Liquidity risk is addressed in the Examiners Handbook as part of the risk-focused examination approach. The Subgroup believes that liquidity risk is a significant risk and recommends, at a minimum that, the NAIC Financial Analysis Handbook be reviewed and potentially strengthened to better address portfolio liquidity risk.

National Association of Insurance Commissioners

Securities Valuation Office

Call Risk

Call risk is the risk that an issuer may elect to retire an asset, in whole or in part, when the investor would have preferred that the asset remain outstanding. Call risk and extension risk are closely related.

Call risk is currently addressed for life insurers through asset liability management, statutory cash flow testing and RBC C-3 Phase I. Call risk is required to be disclosed in the bond characteristics in Schedule D for all insurers but the details of the call provisions for a security are not readily available to state insurance regulators. Provisions should be made for facilitating access by regulators to the specific call features, possibly by including them in the SVO database project.

Extension risk

Extension risk is the risk that an issuer may elect not to retire an asset, in whole or in part, prior to its maturity date when the investor might have anticipated and might have preferred early retirement.

Extension risk is currently addressed for life insurers through asset liability management, statutory cash flow testing and RBC C-3 Phase I. Extension risk is required to be disclosed in the bond characteristics in Schedule D for all insurers. Provisions should be made for facilitating access by regulators to the specific extension features, possibly by including them in the SVO database project.

We also discussed how mortgage-backed securities are impacted by call and extension risk. In the case of mortgage-backed securities, the cash flow depends on the timing of principal repayments made by the borrowers in the pool of mortgages that serve as collateral for the security. Prepayment risk is the risk that borrowers will prepay all or part of their mortgage sooner than anticipated. Extension risk is the risk that prepayments will be slower than anticipated.

Currency Risk

Currency risk is the risk that a nondollar-denominated bond (i.e., a bond whose payments occur in a foreign currency) has uncertain U.S. dollar cash flows. The dollar cash flows are dependent on the foreign exchange rate at the time the payments are received.

Payments linked to foreign exchange rates are required to be disclosed in the bond characteristics codes in Schedule D. The Subgroup believes that currency risk is adequately disclosed in the annual statement, but recommends that the IAWG review the disclosures for potential enhancement.

Leverage Risk

Leverage risk is the risk associated with increasing the volatility of periodic payments. Using leverage, principal repayment terms also may be structured to increase their uncertainty, which increases credit risk. Security specific leverage is generally accomplished through structuring periodic payments according to formulae.

Rating agencies consider the risk of credit leveraging when assigning a rating to a security or a tranche of a structured security. Therefore, the risk of credit leveraging would be captured through the C1 (Credit Risk) component of the life RBC formula. In the situation where periodic payments (e.g. interest payments) may be leveraged, modeling of the security in C-3 Phase I of the life RBC formula would capture the impact of leveraging of periodic payments of the security in the Asset-Liability mismatch risk.
Leverage risk is required to be disclosed in the bond characteristics codes in Schedule D which identifies when the insurer can vary the amount of periodic payments.

National Association of Insurance Commissioners

Securities Valuation Office

Other Considerations

- We also discussed the Bond Characteristics (Schedule, D Part 1, Column 5) and their development during the implementation of Provisional Exemption to enhance disclosure. Realizing that credit ratings referred only to default risk (and its costs), IAWG members sought a mechanism to flag risks other than credit risks. Disclosure of these risks (call, foreign currency *etc*.) for each individual asset was considered at the time to be an enhancement to the explicit reliance on ratings based solely on credit as the basis for AVR and C-1. The IAWG should consider expanding the Bond Characteristic codes to enhance disclosure and transparency.

- It was pointed out during our discussions that we need to be thinking about the cumulative effect of a specific risk across a number of asset classes. It could be more significant than just an individual security.

- There were also seventeen additional risks that were considered as part of our discussions. Those risks are outlined in Exhibit 2. The discussion on most of those risks was very short since the Subgroup members quickly agreed that they were not individual security risks. In some instances, the risks were already embodied in the eight risks that were deemed to be individual security risks. In many instances, we agreed that they represented legitimate risks but were not individual security risks. The details on the risks deemed not to be individual security risks are documented in Exhibit 2 (further details are contained in the minutes from the meetings which are included in the Appendix).

- We had an interesting discussion on conversion risk. If a security has a mandatory conversion provision, it is treated in RBC as if it had already converted so the risk is addressed from a solvency supervision standpoint. If the conversion is not mandatory, there is no incremental risk because the conversion is at the investor's option. We concluded that conversion risk does not warrant further attention at this time but this should be documented in our work product.

Recommendations

The Risk Subgroup recommends:

- The Capital Adequacy Task Force should review the default studies periodically (at least every five years or more frequently if circumstances dictate) to determine whether material changes have occurred. Based on that review, a more in-depth review may be warranted.
- The NAIC Financial Analysis Handbook should be reviewed and potentially strengthened to better address portfolio liquidity risk.
- The IAWG should consider expanding the current database project by the SVO, or other alternatives to address regulators concerns about additional data on call and extension characteristics of specific securities.
- The VOS Task Force should consider expanding the Bond Characteristics codes to incorporate additional needs of regulators to identify attributes of securities.
- The Subgroup believes that currency risk is adequately disclosed in the annual statement, but recommends that the IAWG review the disclosures for potential enhancement.

National Association *of* Insurance Commissioners

Securities Valuation Office

Exhibit 1

Individual Security Risks

Credit risk is the risk of non-performance of contractual payment obligations on bonds, cash equivalents and other invested assets with the characteristics of fixed income instruments.

Event risk is the risk of regulatory changes or other external occurrences that are significant, unanticipated and external, which impact the value of a security.[1]

Liquidity risk is the risk that an investor will not be able to buy or sell an asset into the market with the expected bid/ask spread, anticipated price continuity or sufficient depth; thus causing price realization or execution that is unfavorable or nonexistent.

Call risk is the risk that an issuer may elect to retire an asset, in whole or in part, when the investor would have preferred that the asset remain outstanding.[2]

Extension risk is the risk that an issuer may elect not to retire an asset, in whole or in part, prior to its maturity date when the investor might have anticipated and might have preferred early retirement.

Deferral risk is the risk of the issuer's right to delay payments of interest or dividends (temporarily or indefinitely) on certain instruments.

Currency risk is the risk that a nondollar-denominated bond (i.e., a bond whose payments occur in a foreign currency) has uncertain U.S. dollar cash flows. The dollar cash flows are dependent on the foreign exchange-rate at the time the payments are received.

Leverage risk is the risk associated with increasing the volatility of periodic payments. Using leverage, principal repayment terms may be also structured to increase their uncertainty, which increases credit risk. Security specific leverage is generally accomplished through structuring periodic payments according to formulae.[3]

[1] Includes governmental actions that limit payments from borrowers that are otherwise willing and able to fulfill their obligations.
[2] In the case of mortgage-backed securities, the cash flow depends on the timing of principal payments made by the borrowers in the pool of mortgages that serve as collateral for the security. Prepayment risk is the risk that borrowers will repay all or part of their mortgage sooner than anticipated. Extension risk is the risk that prepayments will be slower than anticipated.
[3] As an example of leverage risk under this definition, Inverse Floating Rate instruments may be used to lever the risk and returns of periodic payments (*e.g.*. interest payments). Other instruments, such as Collateralized Debt Obligations, or CDOs, can be used to lever credit risk (as defined herein) and the effect of this leverage is reflected in rating agency ratings, NAIC Designations and C-1 factors.

National Association of Insurance Commissioners

Securities Valuation Office

Exhibit 2

Risks Not Considered as Individual Security Risks

Conversion risk of a mandatory convertible security is not an individual security risk.

Systemic or systematic risk is not an individual security risk because it relates to classes of securities, securities markets or even broader market place.

Reinvestment risk is not an individual security risk but is considered a portfolio risk.

Refinancing risk is not an individual security risk and is already covered in call and extension risk.

Prepayment risk is part of call and extension risk.

Political risk is not an individual security risk and is already considered as part of event risk.

Sovereign risk is not an individual security risk and is already considered as part of event risk.

Recovery risk is not an individual security risk since it already covered in credit risk. This was confirmed in discussions with rating agencies and by reviewing their documentation.(See Exhibit 5)

Risk of permanence is not an individual security risk but is an example of extension risk.

Option risk is already addressed in other risks (call, extension and leverage).

Market risk is not an individual security risk since it is the sum of all the other individual security risks which have already been identified.

Reinsurer risk.

Counterparty risk.

Lack of accountability risk.

Yield-Curve (Maturity) risk.

Inflation risk.

Market manipulation risk.

National Association of Insurance Commissioners

Securities Valuation Office

Security Specific Investment Risks and the Insurance Regulatory Framework

EXHIBIT 3

Risk	Manner in which addressed in the 2008 regulatory framework	Recommendations
Credit	Covered through C-1	Capital Adequacy Task Force should review the default studies periodically (at mininium every five years) to determine whether material changes have occurred. It is important to note that the default studies by their nature are backward-looking and need to incorporate low probability/high severity events (such as a depression). These studies should be reviewed periodically since financial innovation may impact future experience.
Event	Covered through C-1 in the aggregate if it results in default In other cases not addressed since it is unanticipated The balance of the risk is addressed in C-4 for life insurers.	None
Liquidity	Important at the portfolio level and how it impacts the insurance company Not explicitly addressed in current structure for RBC or reporting Companies use varied internal calculations to monitor liquidity Risk-focused exam can be a platform for examining and assessing company liquidity practices	NAIC Financial Analysis Handbook needs to be reviewd and potentially strengthed to address liquidity risk.
Call	Covered through ALM and C-3 Phase I for life insurers only. Covered through statutory cash flow testing for life insurers. Required to be disclosed in the bond characteristics codes in Schedule D.	Provisions should be made for facilitating access by regulators to the specific call features, possibly by including them in the SVO database project.
Extension	Covered through ALM and C-3 Phase I for life insurers only. Covered through statutory cash flow testing for life insurers Required to be disclosed in the bond characteristics codes in Schedule D.	Provisions should be made for facilitating access by regulators to the specific extension features, possibly by including them in the SVO database project.
Deferral	Covered through C-1, see reports from AAA and Hybrid RBC Working Group It is noted that NRSROs rate for significant deferral risk Required to be disclosed in the bond characteristics codes in Schedule D.	None
Currency	Payments linked to foreign exchanges rates are required to be disclosed in the bond characteristics codes in Schedule D.	The Subgroup believes that currency risk is adequately disclosed in the annual statement, but recommends that the IAWG review the disclosures for potential enhancement.
Leverage	Required to be disclosed in the bond characteristic codes in Schedule D and identifies where the issuer can vary the amount of periodic payments. The risk of credit leveraging is addressed in C-1.The leveraging of interest rate risk is addressed in C-3 Phase I of the life RBC formula.	None

National Association of Insurance Commissioners

Securities Valuation Office

Exhibit 4

Financial Innovation

The members of the Subgroup considered the risks related to financial innovation (a/k/a financial engineering, financial structuring), including modeling risk, information risk, and complexity risk. Fixed income investments subject to such risks include, but are not limited to: callable/escrowable municipal bonds, municipal inverse floaters, auction rate securities (ARS), mortgage backed securities (including pass-throughs, CMOs, IOs/POs and other MBS variants), asset backed securities, and cash market and funded synthetic collateralized debt/loan obligations (CDOs/CLOs). Any security that is not a straightforward non-callable bond would be subject to some degree of the risks attendant to financial innovation. However, a true statement for the general category may not be true (in a practical sense at least) for an individual security in that category. For example, a cash market AAA CDO tranche would arguably have less risk under almost all conceivable circumstances than the underlying pool of collateral, financial engineering notwithstanding. Further, a true statement for the general category may not be true for an individual security when considered in an asset portfolio context – for example, MBS IOs (which may be used as a tool to reduce portfolio duration – arguably reducing interest rate risk). These examples begin to illustrate the challenge of a one-size-fits-all approach, or a security specific approach, to characterizing financial innovation risk.

As evidenced by the instruments listed above, financial innovation is not a new market phenomenon. Relative to non-callable fixed income instruments, financially engineered instruments generally require more sophisticated analysis (including modeling) and more information to properly characterize their expected cash flows, the risks associated with timely (either premature or belated) and complete receipt of these cash flows, and as events have recently unfolded, in some cases, their liquidity. The members of the sub-group were in general agreement that financial engineering risk is, at least conceptually, security specific. For instance, the risks presented by student loan ARS are completely different from the risks presented by funded synthetic corporate CDOs, and derive from the respective nature of the underlying collateral and the structure of the instruments. Analysis of the risk, therefore, naturally requires an understanding of the specific characteristics of the instrument in question. However, comprehensive characterization of the risks generally extends beyond instrument specifics, and for many instruments includes an underlying interest rate simulator/generator (generally monte carlo or lattice based, depending on the particulars of the instrument). Interest rate simulators are at the heart of many fixed income instrument risk analyses, and their implementation involves as much judgment and skill as the modeling of the specific instruments. In some cases, the nature of the instrument requires modeling of default correlations – a non-security specific (more accurately a cross security) parameter. These realities complicate a myopic focus on the security specific aspects of the risk in question.

There was considerable debate within the sub-group regarding whether financial innovation represents an individual security risk or an operational risk. However, there was agreement that it is a legitimate concern and should be addressed within the regulatory framework. The sub-group felt that is less important that financial innovation be characterized as an individual security risk, than it is for regulators to have a process to identify securities that are so affected, so that they can engage companies in further dialogue about how they manage the risks often attendant to these securities.

Summarizing the preceding, the general sense of the sub-group is that 1) the risks presented by financial innovation represent a legitimate concern worthy of regulatory attention, 2) while aspects of the risk are security specific, a security specific approach to addressing such risk is incomplete and otherwise problematic, and 3) a more appropriate approach to handling financial innovation risk is to regard it as a subset of operational/management risk, and to improve the regulatory review of management processes and expertise. Further, the sub-group recommends that the IAWG consider ways to make improved security information more readily available for regulator use, perhaps through the Bond Characteristics column of Schedule D.

National Association of Insurance Commissioners

Securities Valuation Office

Exhibit 5

Recovery Ratings and Loss Given Default Assessments
How Standard & Poor's and Moody's Incorporate Recovery and Losses Following Default in Their Ratings Processes

Prepared by:

Jeffrey L. Evans, CFA
NAIC SVO
IAWG subgroup on Risks
07/24/2008

Both of the two largest NRSROs incorporate recovery analysis (S&P) or loss given default assessments (Moody's) in their below investment grade corporate ratings. Essentially, in their efforts to incorporate recovery in default, both rating agencies notch lower (usually) or higher (less frequently) from the baseline probability of default rating. Thus, the issue rating as published is a blend of the strict probability of default, combined with recovery of the investment in the event of a default.

The notching is based on the agencies' assessments of what proportion of the face value of the obligation a debt holder is likely to receive on their investment should the issuer default on its obligations. These assessments are influenced by three main factors: 1) the quality of the collateral of the issuer overall; 2) by the relative size of the claim relative to the collateral; and 3) the order of priority of claim in the capital structure that each issue represents. An issue backed by substantial collateral, that is higher in priority, will be notched higher; while one backed with little or no collateral, that it lower in priority, will be notched lower

Conceptually, this means that between two issues with the same rating (say "B+/B1" rated senior subordinated bonds of ABC and XYZ); one (XYZ) might actually be more likely than the other (ABC) to default. In default, however, expected recovery on XYZ would be higher than ABC.

The methodologies by which the two rating agencies arrive at their conclusions are very different in process, if not so greatly different in outcome. For a discussion on the agencies' respective methodologies, see S&P "Corporate Ratings Criteria 2008", available at:

http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/2,1,1,4,1204836634695.html[1]

"Probability of Default Ratings and Loss Given Default Assessments for Non-Financial Speculative-Grade Corporate Obligors in the United States and Canada" is available at:

http://www.moodys.com/cust/content/loadcontent.aspx?source=staticcontent/free%20pages/LGD/lgdadpage.htm[2]

What follows is an examination of the hypothetical case above, following the steps that end with identical ratings, but with different probabilities of default and corresponding different levels of expected recovery.

For the two issuers, ABC and XYZ, to have identical issue ratings but with different probabilities of default, they must have different baseline or enterprise level ratings. In S&P's nomenclature, this is called a Corporate Rating, or an Issuer Rating.

[1] Free registration is required. Once logged in, click "Research and Knowledge/Criteria & Methodologies/Ratings – Corporates.
[2] Free registration is required. Once logged in, this report is listed under "Reports" dated August 23, 2006.

National Association of Insurance Commissioners

Securities Valuation Office

Moody's calls it their Corporate Family Rating. In the case of ABC, imagine that it has an Issuer rating of "BB+" from S&P and a Corporate Family Rating of "Ba1" from Moody's. XYZ, on the other hand, has an S&P issuer rating of "B" and a corporate family rating from Moody's of "B2." In this case ABC and XYZ baseline or enterprise level ratings are four notches apart, with ABC rated higher. It is interesting to note that using Moody's published historical default statistics, a "B2" rated bond has a nearly 36% likelihood of defaulting over 10 years, while for a "Ba1" rated bond the likelihood of default over 10 years is just over 10%.

Let us assume that ABC is a company that has relatively little collateral for bondholders to claim in the event of a default. ABC could be a services company that is rated on the basis of its cash flow. Let us further assume that there is a substantial amount of debt on ABC's balance sheet that is senior to the issue in question. Should ABC default, what little collateral there is would be claimed by the senior debt holders, leaving nothing for the issue we are looking at. In this case, both S&P and Moody's might notch ABC's senior subordinated debt *lower* by two steps, to "BB-/Ba3."

With the other issuer, assume that XYZ, although lower rated, has good collateral for the bondholders. Perhaps it is a company with more leverage, or a weaker competitive position, but one that has valuable and marketable assets for collateral. XYZ might be an independent oil producer with proven oil reserves in its portfolio, reserves that would fetch a good price from another buyer. Let us further assume that XYZ has very little debt on its balance sheet that is senior to the issue in question. Were XYZ to default, the senior subordinated investors could expect to receive the full face value of their investment, because the collateral coverage is so strong. In this case, both agencies might notch XYZ's senior subordinated debt *higher* by two steps, to "BB-/Ba3."

Mike Monahan
Senior Director, Accounting Policy
202-624-2324 t
mikemonahan@acli.com

September 12, 2022

Ms. Carrie Mears, Chair
Valuation of Securities Task Force
National Association of Insurance Commissioners
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Amendment to the P&P Manual to Update the Definition of Other Non-Payment Risk Assigned a Subscript "S"

Dear Ms. Mears,

The undersigned (ACLI, PPiA, NASVA) appreciate the opportunity to comment on the exposure, referred to above, that was released for comment by the Valuation of Securities Task Force (VOSTF) at the NAIC Summer National Meeting.

The undersigned are also appreciative that the Securities Valuation Office (SVO) was willing to work with industry to try and gain a mutual understanding of non-payment risk to the new additions and existing language being proposed, including with PPNs, and significant progress was made. However, we are still concerned with various aspects of the proposal.

Relevant Background Information

The proposal references at least three parts (parts one, two and three) of the P&P Manual. The proposal itself proposes changes to part two but defers proposed changes to part three. Our comments reflect the assumption that the de facto second phase of this proposal would be to make subscript S securities non-filing exempt. This is an important assumption that is reflected in our comments.

Further, our comments reflect the fact that the P&P Manual at times can be very difficult to navigate due to its complexity and often conflicting guidance. For example, this was illustrated by the second item, of the July 28, 2022 summer national meeting agenda, where the SVO itself highlighted several conflicting statements in relation to clarifying its role in relation to Interpreting Accounting and Reporting. This proposal was ultimately adopted with the support of industry. Our comments here attempt to simplify and avoid unproductive debate on potentially conflicting or ambiguous language in the P&P Manual.

In simple terms, we understand Subscript S to mean any security that has non-payment risk in addition to the credit risk of the issuer. We believe this provides a more readily available foundation rather than trying to include the many references and inferences within the P&P Manual that may be confusing or contradictory.

More specifically, we note that the P&P Manual (paragraph 37) notes that an NAIC designation reflects credit risk does but does not measure prepayment, extension, or liquidity risk. Paragraph 37 is the foundational language in the P&P Manual describing what an NAIC Designation measures.

Eight Proposed Illustrations of Subscript S Non-Payment Risk

Our approach is to offer perspective on each of the eight illustrations being proposed and address where we believe there is (or isn't) non-payment risk that should ultimately cause a security to no longer be filing exempt and/or where the language is ambiguous or unclear.

Illustration 1 – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield currency sufficient to buy a defined principal amount of U.S. dollars. ~~The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.~~

Non-payment risk – We agree that this illustration highlights a security that has non-payment risk. This describes a dollar denominated bond whereby the payment at maturity, is denominated in US dollars, whereby repayment may not be repaid in full because it depends upon an exchange rate.

However, we suggest the highlighted (i.e., shown with a strike through) language be removed for clarity purposes – i.e., so as to ensure that language is not meant to construe that all foreign denominated bonds (i.e., not a dollar denominated obligation) have non-payment risk. Foreign denominated bonds are funded in a foreign currency with the expectation that both interest and principal will be received in the same foreign currency. Further, the majority of such insurance company investments are hedged for foreign currency risk. Therefore, any notching by the SVO would be inappropriate.

Illustration 2 – A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.

Non-payment risk – We agree that this illustration represents a security that has non-payment risk. Essentially, by allowing a perpetual security that can miss scheduled interest or dividend payments that are not required to be paid on a subsequent date, such a security could be construed as permanent equity-like capital and would not meet the requirement of a bond for NAIC purposes.

Illustration 3 – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity date (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.

No Non-Payment Risk – This illustration appears to address two distinct items:

1 - Perpetual Bonds – Perpetual bonds have contractual terms that require perpetual interest payments (e.g., a perpetuity). There is no risk beyond credit risk that needs to be assessed. The accounting for perpetual bonds is being determined by SAPWG. Where accounted for as bonds, they are required to be reported at fair value. Further, if the credit quality is affected, such credit deterioration is reflected in risk-based capital in two different ways – a lower credit rating and lower risk-based capital due a lower value through fair value accounting.

2 – Bonds with maturities equal or exceeding 40 years – 40-year bonds are quite common, including from household names (e.g., Apple and Microsoft, etc.), for which insurance companies invest. These are used, in part, to match insurance company liabilities with expected payments that are 40 years or even greater. Just recently Union Pacific Corporation issued a 50-year bond. Moreover, many insurance companies have invested in 100-year bonds from prominent universities (e.g., Yale, MIT, Tufts University, California Institute of Technology, etc.). There is no risk, other than credit risk, associated with these bonds. Notching such investments by the SVO, with no deterioration in credit risk, would potentially disincentivize insurance companies from prudent investment decisions.

Illustration 4 – A Principal Protected Security, as defined in Part Three of this Manual.

Non-Payment Risk – As illustrated in Part Three of the P&P Manual.

Illustration 5 – A security with no contractual events of payment default.

Non-Payment Risk – A security that has no contractual events of payment default (i.e., no repercussion due to a missed payment) has non-payment risk beyond the credit of the issuer.

~~Illustration~~ 6 – A security with contractual terms that have the potential to result in payment of contractually promised interest and/or return of principal in an amount less than the original investment amount of contractually promised interest and/or principal.

Non-Payment Risk – A security that has contractual terms that have the potential to result in payment of contractually promised interest and/or return of principal in an amount less than the original amount contracted for, have risk of non-payment beyond the credit risk of the issuer. However, to ensure there is appropriate clarity, we suggest the proposed changes shown above (e.g., proposed changes shown with strike-through and underline) to ensure the written language would not inappropriately or unintentionally capture any security issued at a premium.

Illustration 7 – A security with deferred principal payment features that are at the option of the issuer, not including grace periods of up to 30 calendar days.

No Non-Payment Risk – A security where the issuer has the right to defer principal payment (analogous but opposite to call risk) does not have additional repayment risk beyond the credit risk of the issuer (as long as the bond accrues interest during the extension period).

Many securities have the ability to defer principal payments for a year, or even longer, and can be advantageous in a securitization because it can prevent distributions in kind to an insurer. This is advantageous because the insurer does not want distributions in kind, and also wants the issuer (a loan in an over-collateralized securitization) to have operating flexibility for the best exit strategy to best maximize returns. While it may represent some degree of liquidity risk, liquidity risk is not part of an NAIC designation, and the SVO is not suited to assess the overall liquidity risk of an insurer.

Such features can also actually reduce liquidity risk by preventing distributions in kind. It may also lower credit risk, by giving the borrowing company in the securitization the needed operating flexibility to maximize returns. Extension risk is also not part of an NAIC designation. If liquidity risk and extension risk are of concern to regulators, this is best served by requiring a disclosure on schedule D where such securities can be viewed in aggregate and in the context of the whole host of other information needed to assess the liquidity risk or extension risk related to any specific insurer. Any individual security (or group of securities) may potentially create liquidity risk for one company, but not another, depending upon their products, investments holdings, etc. so notching NAIC Designations, while beyond the purview of the SVO for liquidity risk, would also be inappropriate. If it would be of value for regulators to understand the extent a company holds securities with "extension risk" in the context of liquidity risk, disclosure on Schedule D may be a more appropriate solution.

Illustration 8 – A security with interest payment deferral feature that does not capitalize interest into principal <u>(or does not require deferred interest to accrue at a compound rate</u>) or permits interest deferral, <u>that is not capitalized or compounded</u>, for greater than twelve months or past legal maturity.

Non-payment risk – Many securities have deferral of interest features that get capitalized (payment-in-kind or PIK securities) that have the advantages as described in our response to Illustration 7 but also in situations where the securitization is in the "ramp up phase" (i.e., in the process of investing in the underlying investments) and may have temporary "liquidity issues". This is viewed as a favorable feature by insurance company investors as it actually decreases overall liquidity risk. In this instance, or where interest is deferred and compounded, insurers are more concerned about being made whole and this is factored in when making the investment. This example addresses situations where the interest is not capitalized, and we agree that this presents non-payment risk beyond that of credit risk. For the sake of clarity, we therefore proposed adding the language highlighted (underlined).

However, some have expressed concern that the proposed language was intended to not imply what our proposed change would suggest – i.e., any deferral of interest, even if capitalized, for greater than 12 months presents non-payment risk. If so, we do not agree as this appears to be addressing liquidity risk which is not part of an NAIC Designation. A counter-intuitive, inappropriate and unintended result would be that this scopes in zero coupon corporate bonds, and even zero-coupon US Treasuries, which capitalize interest deferrals through the life of the bond.

Any individual security (or group of securities) may potentially create liquidity risk for one company, but not another, depending upon their products, investments holdings, etc. so notching NAIC Designations, while beyond the purview of the SVO for liquidity risk, would also be inappropriate. If it would be of value for regulators to understand the extent a company holds securities with "PIK" features, in the context of liquidity risk, disclosure on Schedule D may be a more appropriate solution.

Other Practical Issues

Requiring securities, that do not have non-payment risk, to be filed by the SVO for a designation (i.e., they would not be filing exempt) would also present the following two practical issues.

For the securities highlighted above with no non-payment risk, this would require the filing of these securities with the SVO with all the requisite documentation required for such a filing. In addition to the cost, such information may not be available to the investor as it was not contemplated at the time of investment.

Also, certain securities highlighted above with no non-payment risk (e.g., 40 year or greater maturity, PIK interest, extension risk) are of a nature that cannot be designated by the SVO (e.g., certain ABS) or are already designated by the SVO (e.g., CMBS/RMBS).

In conclusion, it is very important that any language related to Subscript S, with the expectation that such securities will eventually need to be filed with the SVO, be very clearly articulated and truly represent non-payment risk. Further, if regulators would benefit from better understanding the extent to which insurers hold securities with risks (e.g., liquidity risk, extension risk, or long maturities, etc.) which do not reflect non-payment risk, we believe disclosure of these risks on Schedule D would better assist regulators assessing such risks holistically. As Schedule D reporting is currently being revamped by SAPWG, the timing for such a solution is perfect.

We stand ready to assist regulators and staff with regards to this proposal. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

MMonahan

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey
Tracey Lindsey
NASVA

John Petchler
John Petchler
on behalf of PPiA
Board of Director

ATHENE

June 29, 2023

Ms. Carrie Mears
Chair, Valuation of Securities (E) Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Via email: ctherriault@naic.org and dgenaorosado@naic.org

RE: Proposed P&P Manual Amendment to Update the Definition of an NAIC Designation

Dear Ms. Mears:

We appreciate the opportunity to comment on the above-mentioned amendment. As we stated in our June 9, 2023 letter to the Risk-Based Capital Investment Risk and Evaluation Working Group, we are concerned that the NAIC has commenced systemic changes to the regulatory capital framework without first having conducted the necessary comprehensive analysis to ensure consistency across asset classes and risks. Consumers are facing a retirement income crisis with fewer available options. Opaque regulatory capital tools, such as the revisions to the SVO's Subscript S authority, will damage insurers' abilities to invest with transparency and capital certainty. Eventually, this will unnecessarily impede insurers' ability to offer products that address the retirement income crisis. We respectfully submit that the NAIC membership should first consider and address the following broader questions that are relevant to the regulatory capital framework for life insurers:

(1) What is the specific problem that needs to be solved by this and related proposals?

(2) What are the relationships among regulators, credit rating providers (CRPs), the SVO/SSG, and insurers regarding NAIC Designations and determination of credit risk and what methods are used?

(3) Have NAIC members fully considered the legal and regulatory ramifications in assigning to the SVO powers that are a combination of both regulatory and CRP in nature?

(4) What governance is present to ensure a consistent calibration given the multiple proposals across asset classes, NAIC Designations, and charges?

(5) Does this and related proposals further the NAIC's stated 2023 priority of reducing the protection gap for an already underserved American consumer base?

(6) Have the NAIC members, through an open and transparent fiscal and governance process, fully considered the resource and budgetary needs associated with empowering the SVO to take on this and related responsibilities?

With regard to this particular technical initiative, the SVO has proposed revisions to Subscript S by (i) expanding the scope of securities to which Subscript S applies and (ii) expanding the SVO's ability to notch designations. The SVO justifies the proposal on the basis that "credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes." The amendment proposes to capture non-payment risks not designed to be included within the C-1 Framework, such as volatility/interest rate risk, prepayment, extension, and/or liquidity risk.

We can understand the logic for creating a tool to address regulatory considerations related to certain repayment features. However, we observe the following critical and unresolved issues:

- It is unclear (i) which CRP methods are deemed to be unfit for designations and (ii) what regulatory assumptions are not currently being considered by the CRPs. No data, analysis or examples have been advanced in support of the assertion that the CRPs' ratings do not appropriately consider "other non-payment" risks.
- No framework exists to consider how risk from these features might be compared to other features or methods, or to other pressing market risks not currently being studied, such as commercial real estate equity and the decreasing quality of corporate bonds over time.
- References to NAIC Designations not capturing volatility/interest rate risk, prepayment, extension, and/or liquidity risk, which are purposefully not otherwise included in C-1, suggest that the SVO proposes to capture such risks by means of notching under Subscript S.
- While the proposal references the use of NAIC Designations in RBC charges, there is no acknowledgment of other parts of the regulatory framework, such as reserving, suggesting a lack of consideration for implications to the overall regulatory framework.

When considering these concerns, the proposal should be compared against other potential effective means to address the SVO's purported regulatory concerns, such as a review of STAT and RBC frameworks and assessing possible limitations that may arise under STAT or RBC in relation to NAIC Designations based on CRPs' existing models. Eventually, with significantly increased CRP assessment and transparency, regulators should consider potential minimum standards for CRPs in lieu of or before individual security notching. A holistic framework setting forth such minimum standards for CRPs would permit state insurance regulators to challenge CRP practices not meeting regulatory assumptions and concerns, while also providing transparency to CRPs and the industry with respect to such assumptions and eliminating potentially duplicative regulatory tools (such as this Subscript S authority and the proposed SVO general authority to challenge CRP ratings).

Liquidity Risk as a Factor in Determining NAIC Designations

NAIC Designations have never been intended to measure liquidity risk. We single out liquidity as a clear example of an "other non-payment" risk that is currently and deliberately addressed through other mechanisms that apply to insurers, including asset adequacy analysis and liquidity stress testing. This separation allows the treatment of liquidity to vary across insurers' business models that have liabilities with varying liquidity needs (e.g., Property and Casualty vs Life). Including liquidity risk within NAIC Designations will inevitably lead to framework inconsistency and disrupt the intentional relationships between C-1 RBC and other parts of the regulatory framework. The Task Force should not adopt revisions to the P&P Manual that would include these risks in NAIC Designations without first consulting with other relevant NAIC committees and working groups.[1]

Scope of the Proposal

The proposed authority appears to apply to a range of structured securities, as well as high-yield corporate and certain other assets. In contrast, the Task Force's prior work on principal protected securities was more narrowly executed and excluded many types of structured securities. We do not dispute the regulatory need to gain a better understanding of these features. However, we believe that any expansion of the SVO's authority should be done in a transparent way that enunciates the specific issues, is narrowly tailored, and provides a list or specific definition of securities to which the new authority would apply. Proposing a significant change in the SVO's authority without sufficient information may cause chilling effects in the market, resulting in lost price transparency and income, ultimately impacting policyholder benefits. We strongly suggest that future proposals should precisely specify the scope of the proposal and a detailed explanation of the rationale for adding each relevant asset class and type of security to the scope.

Notching

Given the concerns outlined above, we do not believe that the expansion of SVO's authority to notch NAIC Designations is currently appropriate. We believe that significant study should be conducted by the Task Force before considering granting any new notching authority to the SVO.

* * * * *

We appreciate the opportunity to comment on this proposal.

Sincerely,

Doug Niemann
Executive Vice President and Chief Risk Officer

[1] We believe revisions such as Subscript S should be discussed within the NAIC Capital Adequacy (E) Task Force, Macroprudential (E) Working Group, Life Actuarial (A) Task Force, and Statutory Accounting Principles (E) Working Group.

AI Anderson Insights, LLC

Christopher Anderson, CFA
Principal
322½ East 50th Street
New York, NY 10022-7902
+1 212 753-5791
chris@andersoninsights.com

June 29, 2023

The Valuation of Securities Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Comments, Staff Proposal: Amendment to Update the Definition of an NAIC Designation in the Purposes and Procedures Manual of the NAIC Investment Analysis Office ("The Manual")

Dear Ms. Mears and Task Force Members,

What is conspicuously missing from the staff proposal is a clear and concise definition of NAIC Designations. This could be presented in a single paragraph or at most on one page. Decision-makers could benefit more from this than from seeing detailed implementation language.

Beginning with such a clear statement would be a sound practice for a number of reasons. The VOS/TF members themselves could evaluate a succinct proposal and decide if there is consensus among themselves about the definition. Then it could reach out to other affected parties, particularly the Capital Adequacy Task Force, to seek broader agreement or they could ask for a similar draft definition from them. When there is general agreement as to definitions then it would be time to direct staff to propose implementation language, such as modifications to manuals, and these drafts would then be examined to determine whether they conform to the agreed definition.

Having discussions, and agreement, on fundamentals at the outset, before drafting implementing documents, would be a sound decision-making practice.

The Need for Designations

The core function of the IAO is to produce risk factors, or Designations, for individual fixed income securities which meet the needs of its key constituent, the Capital Adequacy Task Force, which specifies and administers Risk-Based Capital calculation methods. The VOS/TF has additional functions, to be sure, but to fulfill its own central charge it must direct the IAO in its work as those staff members determine risk metrics on a security-by-security basis that meet the specific requirements for calculating RBC.

Because the CA/TF is responsible for making its own determination concerning what risk elements will be considered in deriving C-1 and R-1 RBC factors it is important to include it in the process at an early stage of deliberations. The VOS/TF has initiated this process so it is underway. The goal should be for the VOS/TF and the CA/TF, as well as others, to arrive at shared understandings of the risks reflected in Designations so they can all fulfill their individual charges.

Comments on the Staff Proposal Itself:

In addition to the foregoing, here are two specific comments, with recommendations, concerning the current version of this concept at the VOS/TF:

29 June, 2023

Development of the VOS/TF's Own Draft Definition

As the VOS/FT considers what risks to include in its proposal for a definition it should take into account existing work done to specify the individual risks of securities, of which credit is just one discrete element. A comprehensive report by the NAIC identified the eight risks to insurer of individual investments.*

This study is the result of considerable effort. While it or may not need to be updated, it is reasonable to expect that same amount of care and effort should be taken before modifying it as was taken in its development itself.

Once there is consensus as to a definition at the VOS/TF level as to a specific definition of Designations then it will be possible to reconcile that with proposals from other NAIC entities.

Evaluating the Full Range of Asset Risk Measures

Beyond just determining NAIC Designations, the IAO continues to serve as a window to the markets so the VOS/TF and insurance regulators can gain an enhanced awareness of developments therein. It can do this by continuing to consider how to develop statistics and risk measures for both individual assets and portfolios to fulfil its various charges. In this process it should work closely with regulators, particularly examiners, to assure that the tools it develops will be useful to them in their work. It should also balance the benefits it expects from this work with the costs of developing and maintaining them. Finally, it should not conflate these efforts with the completely separate charge discussed above of assuring that the IAO deliver the risk measures of individual assets to the specifications set by the Capital Adequacy Task Force for the computation of RBC.

Recommendation: Continue research and development work concerning investment risks

Enhancing the Usefulness of the S Subscript

As presently conceived the S subscript is intended to communicate "other non-payment risks". This subscript can potentially be useful, but it needs to be updated to reflect current developments. Credit risk is defined in Part One, ¶37, as "the relative financial capability of an obligor to make the payments contractually promised to a lender" and this is consistent with the findings of the IAWG subgroup. So if "credit risk" is the risk of non-payment how can there be "other non-payment risks" and what could they be? There are two logical possibilities.

The first reason for "non-payment" could be that the investor mistakenly believes that the borrower has made promises when, in fact, it has not. One example of this could be found in principal protected notes. These are actually debt-equity hybrid securities containing elements of each asset type. The only "bond-like" promise is for the return of principal at maturity. PPN investors need to understand that there are no representations of what their returns will be beyond the return of principal. These and many other security types have been addressed in "the bond project" and the results will be reflected in updated accounting guidance. In short, as in the example of PPNs, other assets not providing specific promises of returns will be denied bond status. Accordingly, there is no need to flag these with an S suffix as having "other non-

* Report of the Risk Subgroup of the Invested Asset Working Group (reporting to the VOSTF) August 6, 2008, Attachment two A-9, Minutes of the Valuation of Securities (E) Task Force, 12/06/2008 (submitted to you previously)

payment risks" because in those instances there is not an actual creditor relationship -- they are not eligible to be treated as bonds.

The other possible way there could be a risk of non-payment is that the rating/designation is simply wrong. By its very definition, credit risk is the risk of non-fulfillment of a *promise* to make certain payments. To be accurate and useful ratings/designations must take into account all significant reasons why promises by borrowers might not be kept. This is the very essence of credit ratings. Analysts, their supervisors and credit committees are accountable for taking into consideration relevant factors that could reasonably have adverse effects on a bond not delivering the promises set forth in its agreement with investors. Assuming rating agencies are performing properly then here, too, there is no role for the S subscript. If it is determined that rating agencies are <u>not</u> performing properly then corrective action must be taken.

So where and how can the subscript be useful to regulators? Here is one example. If in a specific case the S Suffix were used to denote limited liquidity of an asset then regulators could look at the totals of assets with limited liquidity and compare that to the liability posture of an insurer. This could be extremely helpful.

The S suffix doesn't presently indicate any specific reason for its assignment. Accordingly, regulators looking at statements with assets with S suffixes have no idea for the reason for the "S". It could be for liquidity but it could also be for any other number of reasons. This needs to be remedied.

Recommendation: Coordinate with the IAO to learn from regulators themselves which risk elements are of interest and concern to them, in addition to credit risk which is already the essence of a Designation. These other-than-credit risks would then each need to be assigned unique means of identification available to regulators in order for them to be useful.

Summary:

The most important point in this letter is that there is a need for relevant parties to agree on a short concise definition of NAIC Designations and this is primarily the responsibility of the CA/TF.

New risk metrics if justified and using the S suffix to specifically identify risks other than credit risk, would bring greater clarity and insights to insurance regulators. This would have the greatest potential if regulators themselves were actively engaged in developing these enhanced tools.

Christopher Anderson

Copies: For the VOS/TF: Charles Therriault and Denise Genao-Rosado
Thomas Botsko, Chair, Capital Adequacy (E) Task Force
Philip Barlow, Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group
Dale Bruggeman, Chair, Statutory Accounting Principles (E) Working Group

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

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.*

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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.

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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

…

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 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.

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.

…

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

SVO ORGANIZATION

…

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:
…

- **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.

…

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-xxx.01 P&P SVO Discretion.docx

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

July 25, 2023

The Honorable Rep. Warren Davidson
Member of Congress
2113 Rayburn House Office Building
Washington, DC 20515-3508

The Honorable Rep. Andy Barr
Member of Congress
2430 Rayburn House Office Building
Washington, DC 20515-1706

The Honorable Rep. Bill Posey
Member of Congress
2150 Rayburn House Office Building
Washington, DC 20515-0908

The Honorable Rep. Blaine Luetkemeyer
Member of Congress
2230 Rayburn House Office Building
Washington, DC 20515-2503

The Honorable Rep. Scott Fitzgerald
Member of Congress
1507 Longworth House Office Building
Washington, DC 20515-4905

The Honorable Rep. Andrew Garbarino
Member of Congress
2344 Rayburn House Office Building
Washington, DC 20515-3202

The Honorable Rep. Mike Flood
Member of Congress
343 Cannon House Office Building
Washington, DC 20515-2701

The Honorable Rep. Mike Lawler
Member of Congress
1013 Longworth House Office Building
Washington, DC 20515-3217

Dear Chairman Davidson and Representatives Barr, Posey, Luetkemeyer, Fitzgerald, Garbarino, Flood, and Lawler:

We appreciate the opportunity to clarify any confusion and address any concerns you have with the National Association of Insurance Commissioners' (NAIC)[1], ongoing efforts to improve state insurance regulation. We also appreciate your continued support for our national system of state-based regulation, which over the past 150 plus years has worked to ensure the solvency of the largest and most competitive insurance market in the world.

Before addressing the specifics of your inquiry, we want to provide some background on our regulatory approach to insurer investments and capital as well as changes that we are observing in insurer investment behavior, which helps put our current work in context. Insurers have invested more than $8 trillion in our economy and use those investments to support their obligations to

[1] As part of our state-based system of insurance regulation in the United States, the NAIC provides expertise, data, and analysis for insurance commissioners to effectively regulate the industry and protect consumers. The U.S. standard-setting organization is governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer reviews, and coordinate regulatory oversight. NAIC staff supports these efforts and represents the collective views of state regulators domestically and internationally. For more information, visit www.naic.org.

policyholders. The amount of risk-based capital they are required to hold, which directly impacts on their ability to pay claims, is linked to the risk of those investments. All insurer investments are given a "NAIC designation," which corresponds with a prescribed capital factor. If an investment is rated by one or more of the Nationally Recognized Statistical Ratings Organizations (NRSROs)—and roughly 80% of all insurer investments are rated—the NAIC designation is mapped directly to that rating with no further analysis or oversight by state regulators or the NAIC. These are called "filing exempt" or FE securities, in that they do not have to be filed with the NAIC's Securities Valuation Office (SVO) for review.

However, if an insurer chooses to invest in an unrated investment, the SVO provides centralized credit analysis for that security and produces the corresponding NAIC designation. This allows insurers the flexibility to go beyond traditional rated securities, while ensuring that the state regulatory system has confidence in the credit quality of those investments. Due to the vast scope of insurer investments, reliance on NRSROs provides an efficiency that we have no intention of displacing or competing with; however, because our risk-based capital system is linked directly to investment strength, this deference to NRSROs' opinions is not unconditional. It is also worth noting that the work the SVO performs on behalf of the states is for regulatory purposes only and is not released publicly or used to compete with NRSROs.

Insurers, and particularly life insurers, have long been relatively conservative, long-term investors to match the nature and duration of their long-term liabilities. However, a decade of historically low interest rates led to low yields on the traditional treasuries, municipal bonds, and high-quality corporate bonds the industry favored. This in turn compelled many insurers to seek higher yielding, but often more complex, less-liquid, and potentially riskier asset-backed securities, private placements, or other bespoke investments, which require consideration of whether a higher Risk-Based Capital (RBC) charge is appropriate due to increased risk.

In recent years, state regulators have noticed growing discrepancies between the ratings provided by competing NRSROs for the same security—in some cases, five or more notches difference in the ratings. Keeping in mind that the better the rating, the less capital an insurer is required to hold, the potential for "rating shopping" is a real concern and one with historical precedent. Indeed, because of such discrepancies for residential and commercial mortgage-backed securities, revealed during the Great Financial Crisis, we developed a separate credit analysis process for those securities that continues to this day.

In response to growing regulatory concerns with the financial engineering seen in bespoke investments today, the insurance commissioner members of the NAIC's Financial Condition (E) Committee's adopted a charge 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 response to this direction from insurance commissioners on the Financial Condition (E) Committee, the NAIC Valuation of Securities Task Force (the "Task Force"), comprised of state insurance regulators, is now proposing to establish a process by which the SVO would be authorized to challenge the credit rating for a filing exempt security when certain conditions are met. The process, as it was exposed for public comment, would include the following steps:

- Establishment of a materiality threshold required to flag a CRP rating. To limit the SVO's use of this process to only that which would be considered truly material differences of opinion, the SVO would only be able to put a security or CRP rating on notice if it determines, based on the information at hand, that the CRP rating used in the FE process is three or more notches different than the SVO's assessment.
- A means to electronically identify to insurers an FE Designation of concern.
- Sufficient notice to allow an insurer to appeal/provide additional information before any action is taken. Insurers would have up to 120-days to appeal the SVO's assessment by introducing additional information and data, as necessary. This 120-day appeal period is similar to the existing appeal period for SVO assigned NAIC Designations.
- A formal review process by the SVO, with an opportunity for applicable insurance regulator(s) to consult on the deliberation, if they request.

These procedural steps ensure insurers are given due process: ample notification, an opportunity to appeal the SVO's initial assessment, an opportunity to get an alternate CRP rating, and sufficient time to file the security, if needed.

At the request of the Task Force Chair, the SVO would provide a report to a regulator-only meeting of the Task Force 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.

This proposal, as with all NAIC policy proposals, is subject to a transparent and deliberative public comment process that gathers and considers feedback from all interested parties. Interested parties have shared recommendations during the comment period that will be considered and incorporated if deemed appropriate by the Task Force.

NAIC GOVERNMENT AFFAIRS

We believe the proposal, when adopted by our membership, is an appropriate approach to ensure that insurers are holding sufficient capital based on the risk they are taking with their investments and ultimately will leave policyholders better protected. We do not anticipate any competitive imbalance for NRSROs because our work is for regulatory purposes, to arrive at appropriate capital charges, and will not be released publicly or to the broader capital markets. The materiality thresholds we have put in place ensure that challenging a CRP will only commence when a significant red flag occurs, and even then, the notice and appeal process ensures fair treatment for all parties.

While we have no intention of challenging the NRSRO's methodologies or opinions or disrupting the important role they play in our public markets, we are also under no obligation to defer to them without judgment or exception as the de facto driver of our risk-based capital framework. Past financial crises and recent banking turmoil illustrate the importance of regulators ensuring that financial institutions' investments are suited to their customers' obligations, and accurately reflect the risks they choose to take.

We thank you for your interest in our work and your continued support for state-based regulation, and we are happy to provide more detailed briefings to you or any members of your staff on this important work.

Sincerely,

Chlora Lindley-Myers
NAIC President
Director
Missouri Department of Commerce and Insurance

Andrew N. Mais (He/Him/His)
NAIC President-Elect
Commissioner
Connecticut Insurance Department

NAIC GOVERNMENT AFFAIRS

Jon Godfread
NAIC Vice President
Commissioner
North Dakota Insurance Department

Scott White
NAIC Secretary-Treasurer
Commissioner
Virginia Insurance Department

Congress of the United States
House of Representatives
Washington, DC 20515

July 13, 2023

Chlora Lindley-Myers
President
National Association of Insurance Commissioners
444 North Capitol Street NW, Suite 700
Washington, D.C. 20001

Dear Director Lindley-Myers,

It has recently come to our attention that the Securities Valuation Office (SVO), comprised within the National Association of Insurance Commissioners (NAIC), published proposal to the Purposes and Procedures Manual (P&P Manual) that would significantly expand the NAICs discretion over filing-exempt securities.[1] The proposal has the potential to provides risk-based capital uncertainly for all filing exempt investments held by U.S. insurance companies (which includes thousands of CUSIPs), creating liquidity and market disruption. We write to urge you to withdraw the proposed changes to the P&P Manual.

The NAIC retains an essential role as both a unifying body for state regulators and as a standard-setter which ensures the U.S. insurance industry remains strong and robust across the 50 states, the District of Columbia, and five U.S. territories. In this role, the NAIC has held a particularly unique position amongst U.S. regulators for over 150 years. Much of our economic success can be attributed to the NAIC's steadfast mission to support state-based insurance regulation.

Despite the NAIC's successful track record, it was particularly concerning to see the proposal from the May 15th Valuation of Securities (E) Task Force meeting that would allow the SVO to review all filing exempt securities and contest nationally recognized statistical rating organizations (NRSRO) NRSRO ratings if it believes a rating "is not a reasonable assessment of risk of the security for regulatory purposes."[2] Such discretion, which appears to lack any formal methodology, if enacted, would deviate significantly from the NAIC's proper role within insurance regulation. We fear that such discretion would make NAIC regulated entities susceptible to staff-driven agendas.

Additionally, these same proposals could undermine a competitive market amongst NRSROs and exacerbate the SVO's recent gravitation towards becoming an unregulated NRSRO competitor.

While we are aware the SVO has significantly grown its operations and revenue in recent years despite its limited size, the recent proposals would expand the SVO's footprint well-beyond that of a regulator. Should these proposals get enacted, the SVO would become an unregulated, de facto NRSRO and undermine market competition through their unfair competitive advantage.

---

[1] Nat'l Ass'n of Ins. Commissioners, Valuation of Securities (E) Task Force Meeting, May 15, 2023, https://content.naic.org/sites/default/files/call_materials/VOSTF%20Materials%202023-05-15%20v1.pdf (discussing the Proposed P&P Manual amendment authorizing the procedures for the SVO's discretion over NAIC designations assigned through the filing exemption process.)
[2] *Id.*

This unfair competitive advantage would arise from a conflict of interest within the SVO where the SVO would both set fees and designate securities. Using the NAIC's unique position to steer business through its commercial services, while simultaneously incentivizing U.S. insurers to stop using private sector ratings firms, would be an unwelcome paradigm shift.

The state-based regulatory framework continues to be a time-tested model of success. We cannot risk upending this framework by opening the door to SVO staff-driven actions that could ultimately hurt competition, imperil the capital adequacy of NAIC regulated entities, and make it harder for insurer's ability to meet their obligations. We ask that the NAIC withdraw the recent proposals and work to ensure the SVO does not undermine the integrity of our state-based regulatory structure or interfere with competition amongst NRSROs.

Please reach out to my office if you would like to discuss further.

Sincerely,

Warren Davidson
Member of Congress

Andy Barr
Member of Congress

Bill Posey
Member of Congress

Blaine Luetkemeyer
Member of Congress

Scott Fitzgerald
Member of Congress

Andrew Garbarino
Member of Congress

Mike Flood
Member of Congress

Mike Lawler
Member of Congress

Mike Monahan
Senior Director, Accounting Policy
T: 202-624-2324
mikemonahan@acli.com

July 14, 2023

Ms. Carrie Mears, Chair
Valuation of Securities Task Force (VOSTF)
National Association of Insurance Commissioners (NAIC)
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Practices & Procedures (P&P) Manual Amendment Authorizing the Procedures for the Securities Valuation Office's (SVO's) Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears:

The undersigned (ACLI, PPIA, NASVA, SFA, MBA, and CREFC) appreciate the opportunity to comment on the exposure referred to above that was released for comment by the VOSTF on May 15, 2023. We generally like to provide constructive comments on VOSTF exposures and provide support wherever possible. Regarding this exposure, the undersigned have concerns with the proposal and believe additional transparency is warranted. We also recommend changes that are necessary to avoid significant unintended consequences.

Prelude

As discussed at the NAIC Spring National meeting, the undersigned recognize that VOSTF seeks additional information on certain types of insurer investments, with the SVO acting as the "eyes and ears" for Regulators. Further, we recognize that some Regulators may want to grant the SVO some latitude in challenging rating agency ratings if they are deemed not fit for NAIC purposes ("not fit for purpose"). The undersigned stated at the NAIC Spring National meeting, and this was further supported by Texas Regulator, Jamie Walker, that full transparency is warranted for both the NAIC (including the SVO) and the insurance industry, but that is not present in this proposal.

The undersigned appreciate the opportunity to comment and would like to highlight some significant, specific concerns with the exposure. In recent years, the NAIC has made several changes to increase reporting regarding insurer investments, including requiring rating rationale reports as part of the filing exemption (FE) process. As outlined in greater detail below we recommend that any additional changes to the FE process first identify specific ways that NRSRO methodologies are not fit for purpose for a given asset. We also recommend that the NAIC/SVO be transparent about their specific concerns that would warrant such significant changes. Given the magnitude of the potential impacts of this exposure, we also recommend that Regulators convene to study the issue in depth like the study commissioned by the VOSTF in 2008 (referred to in our Subscript S letter dated June 29, 2023). In the interest of providing constructive feedback, the undersigned outline additional transparency and oversight measures below that can mitigate our concerns and help minimize downstream impacts of the proposed exposure. The undersigned believe it is in the best interest of all parties – Regulators, NAIC staff, insurance companies, rating agencies, and capital markets participants – to have complete procedural transparency.

Concerns

1) The exposure currently places the right to challenge a rating or methodology, and the ability to make a final decision on such rating or methodology, solely with NAIC staff and potentially with just one regulator. There is no requirement for oversight from VOSTF, or another sub-group of regulators, to ensure consistency of process or to provide an independent view, should NAIC staff and insurers disagree. This poses due process problems, as well as potential extra-territorial application of one state regulator's decision over insurers domiciled in other states.

2) In the exposure a ratings challenge from NAIC staff starts with staff's view on a designation, having only had access to the Credit Rating Provider (CRP) rating and rationale and to Schedule D information. NAIC staff would lack access to critical information provided in a full security filing when they first determine their proposed designation. Practically speaking, the insurer would then need to informally file the security for a more thorough review from NAIC staff, should the insurer wish to engage in a fully informed dialogue about the security with the SVO or SSG. The exposure treats this subsequent filing and dialogue as a ratings appeal, rather than recognizing that NAIC Designation filings and appeals are separate processes.

3) Should the VOSTF proceed with this proposal, the undersigned believe that there must be a separate appeal process in place, with oversight from an independent party, to ensure due process for insurers. The exposure provides limited transparency to insurers (and to their capital markets counterparties) regarding the SVO's/SSG's rationale supporting a CRP ratings challenge. The only envisaged disclosure is for a challenged rating to be flagged in the NAIC Automated Valuation Service (AVS+). However, there is no requirement for NAIC staff to provide public disclosure regarding why they are uncomfortable with a rating. Instead, such information can only be obtained with a phone call between the filing insurer and the SVO analyst. This is problematic, because other insurers who hold the same security (and other interested capital markets participants) may not be privy to some of the one-off, undocumented discussions. Lack of consistent, public disclosure of the NAIC's concerns leaves room for guessing and misinformation within the capital markets. This could result in market uncertainty and increased illiquidity. The current exposure has already had a negative effect on capital markets. Several transactions have been put on hold, as insurance company investors are sidelined from certain investments, due to the lack of transparency in the current exposure. To date, NAIC staff has provided only limited examples of types of transactions they are concerned about. The lack of further clarity regarding NAIC staff's scope and method of review has created risk-based capital uncertainty for portfolio investments (both current and future). Insurers have a strong need to understand what the NAIC's concerns are with a given rating—especially when NAIC staff are deeming a rating methodology as unfit for regulatory purposes.

4) The exposure does not require staff to publicly report aggregate statistics for ratings challenges. Staff are only required to provide an annual report at VOSTF's request, and even then, such a report would not be shared publicly.

Collectively, the issues highlighted above serve to create a process that, if implemented, would lack transparency, sufficient checks and balances, and the opportunity for insurers (and ratings agencies) to present their data, information, and ratings rationales in a fair, open forum. For example, assume there is an Asset-Backed Security (ABS) where the rating agency rating assumes 10% appreciation in the underlying collateral, but the SVO assumes 0% appreciation and believes their approach is more fit for purpose. The proposed exposure, where any single security rating is challenged based on a methodology concern, would cause several significant problems:

a. One state, working with the SVO, could dictate NAIC Designations for companies in other states where the same security is held.
b. Further, such a security would not be in isolation. The ratings challenge would presumably apply to all similarly situated, rated securities. The challenge would create significant market uncertainty, as it would be unclear to industry and interested parties whether the SVO's concern applied to just:
    i. One CRP's rating methodology, or other CRPs' methodologies as well (i.e., other rating agency methodologies may also assume collateral appreciation, but at different levels).
    ii. That particular legal structure or type of ABS,
    iii. A subset of that particular ABS type,
    iv. A specific, unique structural feature or anomaly in that ABS, specifically (or that would also potentially apply to other ABS as well), or
    v. A general matter of difference in professional judgment of the particular analyst.

Changing any particular security rating within AVS+ would create problems and would not achieve the stated goals of consistency, uniformity, and appropriateness necessary to achieve the NAIC's financial solvency objectives. Ultimately, this would create significant capital markets disruption. The undersigned would like to recommend some changes that we believe would help strike the right balance between the NAIC's need for ratings oversight and with industry's and capital markets' need for transparency and due process.

Suggested Changes to Improve Transparency

Should the VOSTF choose to proceed, we believe a robust and transparent process is warranted. The process should make clear whether a rating is challenged due to (1) a CRP's rating methodology being deemed unfit for purpose, or (2) as a matter of professional judgment (we believe the latter would be relatively rare). The SVO should publicly identify rating agency methodologies that they do not believe are fit for the NAIC's purpose and provide analytical support for such view on each respective CRP methodology in question. Whenever the SVO challenges a rating based on differences in professional judgment, it should provide insight on its own approach for assigning a designation to that security. More specifically, the undersigned's proposed solution includes the following:

1) Whenever a CRP rating is challenged in AVS+, not only should the security's rating be flagged, but there should also be an area in the system that provides a written rationale for why the rating is being challenged. The AVS+ system should include a field that carries a single category description for ease of use in future reporting (e.g., methodology not fit for NAIC purposes, or professional judgment). However, that alone is not a sufficiently transparent explanation. There should also be an attached report or link to a publicly available rationale where the SVO analyst highlights:

   a. Key factors considered in the SVO analysis, and the methodology utilized;
   b. A rationale as to why the CRP's methodology is not fit for purpose (if applicable) or where the SVO analyst's view differs materially from the CRP (if a difference in professional judgment), and
   c. The scope of the population of securities for which the change applies.

2) When NAIC staff challenges a CRP methodology as being unfit for purpose, these challenges should be disclosed publicly and brought to the VOSTF for approval prior to any ratings change. This should include the rating methodology or methodologies (if multiple rating agencies) deemed not fit for purpose, along with a robust rationale, as well as what securities are impacted. Impacted insurers and the relevant CRPs can then present their analyses, including relevant data and security information, models (if applicable) and rationale publicly to VOSTF, and VOSTF can serve as the ultimate arbiter after hearing views from both sides. Benefits of a public discussion include:
   a. Prevents one regulator and the SVO from unilaterally making regulatory decisions that potentially impact other state regulators, other insurers, and other similar securities;
   b. Provides transparency to the Capital Adequacy Task Force (CATF), as it is CATF's responsibility to determine appropriate RBC charges and model factors;
   c. Ensures all enacted changes are in line with the stated goals of consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives;
   d. Aligns the VOSTF's stated goal of engaging further with the CRPs as a consumer of ratings to gain a better understanding of their process, methodologies, and regulatory oversight.
   e. Provides appropriate checks and balances, affording due process for insurers and transparency to all stakeholders.

3) In the case of differences in professional judgment (which we believe would be relatively rare, especially considering the proposed three-notch threshold for a ratings challenge), the SVO/SSG should be required to perform a full security filing review and disclose to the insurers the SVO's or SSG's own applicable methodology, laying out the key considerations and rationale that NAIC staff considers for similar securities.

   If the SVO and impacted insurers are unable to reach agreement on an appropriate designation during the initial challenge process, then it is important for the insurer to have some method of appeal beyond NAIC staff to provide appropriate independent review and ensure consistency to the designation process. The undersigned would not expect insurers to appeal every ratings challenge (nor would it be practical for VOSTF to hear to every such appeal), but there are expected to be key instances where insurers feel strongly that an additional third-party's viewpoint (beyond the SVO/SSG and the original CRP) is needed and helpful. Ultimately, such discussions may help Regulators as well, as it would help them develop a deeper understanding of how investments are viewed by insurers, capital markets participants, and the rating agencies, as well as by the SVO. More discussion is merited on whether the appropriate appeals board should be the VOSTF or some subset thereof. However, the appeals process should include people who are willing to independently consider all views, and who can set policy across all states consistently.

4) As a best practice, all SVO designation methodologies, and a description of the NAIC's process of reviewing and approving these methodologies, should be posted publicly on the NAIC's website. We recognize that the SVO and SSG will not have models or methodologies covering the full bond population. Indeed, no CRP can rate the full bond population, given the sophisticated data gathering, modeling, analytical software and other resources required to rate certain types of securities. However, posting methodologies publicly would highlight areas where the SVO/SSG do not have designation methodologies in place, such as ABS or (currently) Collateralized Loan Obligations (CLOs), and help ensure that those methodologies which do exist are consistently applied, providing transparency to insurers and to capital markets.

5) The undersigned believe industry should be provided with an overall assessment of how this ratings challenge program progresses and is enforced. Aggregated statistics, shared publicly each quarter, would help both Regulators and industry alike to understand the scope of the issues and how the program is progressing. NAIC staff should provide quarterly reports for both VOSTF and the public, highlighting the following for securities challenged:

    a. Number of ratings challenged, for each challenge type;
    b. Number and dollar-amount of CUSIPs challenged;
    c. Outcome of SVO/SSG challenges:
        i. Percentage of CRP ratings affirmed vs. percentage of SVO designation overrides;
        ii. Number of challenges appealed to VOSTF and percentage of appeals where NAIC staff's recommendation to overturn a rating the was affirmed by Regulators vs. percentage of appeals where the original CRP ratings were affirmed;
    d. Average number of notches that ratings were reduced, both on an incident- and dollar-weighted basis.

Further Considerations

The undersigned suspect one concern VOSTF may have with our proposal centers around confidentiality associated with private ratings. However, we think confidentiality concerns are manageable. Federal law requires that NRSROs disclose and maintain their methodologies publicly, and rating methodologies can be found directly on CRP websites. Any questions on such methodologies can be answered through discussions with CRP analysts. Therefore, for situations where NAIC staff is challenging a methodology as not fit for purpose, staff should be able to discuss the methodology that the CRP employed and discuss where the NAIC takes issue with that methodology, without disclosing non-public information. When NAIC staff is challenging a rating based on differences in professional opinion, the underlying CRP rating can be expressed in terms of an NAIC-equivalent designation (as opposed to disclosing the CRP rating directly), and the details of the issuer or structure can be genericized enough to mask the specific security, yet still provide key insights into the reason and rationale for ratings challenges. In fact, the SVO has successfully done this with some limited examples in the past.

The only downside the undersigned see in such approach is additional effort required of the SVO/SSG, but the benefits are many. Enhanced transparency is generally good for any system, but here, it is imperative for insurers to understand what types of investments or ratings methodologies concern the NAIC to limit negative downstream consequences for insurers. This also is necessary to limit capital markets disruption and prevent both investment bankers and insurers from arbitrarily rejecting established private placement debt types as a viable option for insurers' portfolios. Absent more transparency, the market could potentially deem the entire privately-rated debt universe as problematic when Regulators and the SVO have only expressed concerns with a targeted subset of that universe. Insurers need to understand what is and is not problematic, and why, as well as how, the SVO or SSG might view certain types of securities. Further, without transparency, the public debt market (particularly the 144A space) could also experience significant disruption, which could cause unnecessary negative impacts to insurers' investments in such instruments. Any reasonable cost associated with providing transparency and oversight, as outlined in our solution above, would be supported by industry. It is likely minimal in relation to the significant benefits that transparency affords to all stakeholders.

Conclusion

The undersigned stand ready to discuss these ideas further with Regulators and with the SVO/SSG; we are willing to begin discussions immediately. We ask that adoption of the exposure be postponed until the significant philosophical and procedural issues highlighted above can be resolved.

Given the magnitude of this proposed change, and the potential effect on insurers and capital markets, the undersigned believe that this process may be best suited for a comprehensive study by Regulators across disciplines. A working group could be established with members from the NAIC's CATF, Risk-based Capital Investment Risk and Evaluation Working Group, Life Actuarial Task Force, and VOSTF, to holistically address what we understand the broader regulatory concern to be: Whether the NAIC investment risk-based capital regime has kept pace with market innovation. This approach could be patterned after the previously mentioned study commissioned by the VOSTF in 2008 that met extensively over an approximately eight-month time period to define and evaluate perceived shortcomings and issue a formal report. In this instance, a report should have specific recommendations that address defined problems holistically and transparently. The following are some of the issues that the working group could consider:

- Define areas of concern raised by the SVO and by some Regulators with as much precision as possible to properly scope the project;
- Identify whether there are any investment types with significantly different risk characteristics which may warrant additional investment RBC factors (as was suggested by Moody's Analytics at the time of development of current investment RBC factors);
- Identify additional asset classes, if any, where modeling may be appropriate, such as with CLOs; and
- Evaluate any input from the VOSTF Ad Hoc Rating Agency Review group.

Lastly, we also think it is important to recognize that credit analysis is both an art and a science; differences of professional opinion are unavoidable. No one organization (whether an insurer, a CRP or the SVO/SSG) has a monopoly on perfect accuracy when assessing risk. An institution's ability to assess credit risk will inevitably be shaped by unique organizational experiences, risk tolerances, and resources or tools brought to bear in the risk assessment process. Furthermore, each CRP (and NAIC staff) has certain areas of relative strength and expertise and areas where their resourcing and expertise is weaker. Therefore, in addition to defining the concerns with as much precision as possible at the outset, ongoing transparency is key to any process. Industry is, and has been, committed to transparency, as evidenced by our willingness to submit ratings rationale reports and provide transaction documents upon NAIC staff's request. We ask for the same level of transparency from the NAIC.

The current exposure grants the SVO significant unilateral powers, with very little transparency, and without sufficient due process or checks and balances. This proposal, if adopted, would be materially disruptive to the insurance industry. Rather, the undersigned propose that the identified concerns with reliance on CRP ratings be addressed in a holistic way, backed by disciplined and rigorous analysis, with output that is transparent to all parties. This would address Regulator concerns without creating undue market disruption and the other shortcomings that the undersigned have identified in this letter.

The undersigned stand ready to assist in this process in a meaningful way, but we believe that is best done transparently and through collaboration. We believe Regulators understand the importance of transparency and would like to achieve a transparent outcome as well. We appreciate the opportunity to participate in this ongoing process.

Sincerely,

	Tracey Lindsey	John Petchler
Mike Monahan	Tracey Lindsey	John Petchler
ACLI	NASVA	on behalf of PPiA Board of Directors
Lisa Pendergast	Michael Bright	Mike Flood
CRE Finance Council	SFA	Mortgage Bankers Association

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

American Council of Life Insurers | 101 Constitution Ave, NW, Suite 700 | Washington, DC 20001-2133

The American Council of Life Insurers ("ACLI") is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long- term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States. For more information, visit www.acli.com.

The Private Placement Investors Association ("PPiA") is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PPiA serves 66 member companies and works with regulators, NASVA, the ACLI, the American College of Investment Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace. For more information, visit www.usppia.com.

The National Association of Securities Valuation Analysts ("NASVA") is an association of insurance company representatives who interact with the NAIC Securities Valuation Office ("SVO") to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes.

The Structured Finance Association is the leading securitization trade association representing over 370 member companies from all sectors of the securitization market. Our core mission is to support a robust and liquid securitization market and help its members and public policymakers grow credit availability and the real economy in a responsible manner. SFA provides an inclusive forum for securitization professionals to collaborate and, as industry leaders, drive necessary changes, advocate for the securitization community, share best practices and innovative ideas, and offers professional development for industry members through conferences and other programs. For more information, visit www.structuredfinance.org.

MBA is a national association representing the real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets. Its membership of more than 2,200 companies includes all elements of real estate finance: independent mortgage banks, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies, credit unions, and others in the mortgage lending field.

CREFC comprises over 400 institutional members representing U.S. commercial and multifamily real estate investors, lenders, and service providers – a market with over $5 trillion of commercial real estate ("CRE") debt outstanding. Our principal functions include setting market standards, supporting CRE-related debt liquidity, facilitating the free and open flow of market information, and education at all levels. One of our core missions is to foster the efficient and sustainable operation of CRE securitizations. To this end, we have worked closely with policymakers to educate and inform legislative and regulatory actions to help optimize market standards and regulations.

The Lease-Backed Securities Working Group

July 14, 2023

Ms. Carrie Mears, Chair
Valuation of Securities Task Force
National Association of Insurance Commissioners
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: P&P Manual Amendment Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears:

Our group, *The Lease-Backed Securities Working Group*, appreciates the opportunity to comment on the proposed amendments to the P&P Manual described above. We have a number of concerns about the proposal, which we discuss below, but we also want to suggest several ways in which the proposal could be improved to mitigate some of those concerns.

Primarily, we do not believe that this policy -- which permits the IAO to selectively review and overturn NRSRO ratings of individual securities -- could be implemented without causing massive disruption in the capital markets. For markets to function, investors need to have confidence *when purchasing a security* that they can accurately anticipate the risk factors -- and the related capital charges -- associated with that purchase. For insurance companies, this predictability is currently achieved through the Filing Exemption process, which insures that all bonds with the exception of structured securities (CLOs, CMBS and RMBS) are "*entitled to a presumption of convertibility to* ***the equivalent NAIC designation***" (P&P Manual, Section 2). *Any* uncertainty associated with the assignment of risk-based capital charges is bound to put a damper on markets.

This uncertainty is aggravated by the observation by market participants that SVO-assigned designations historically have varied widely -- even among securities with similar characteristics -- and likewise bear no fixed relation to NRSRO ratings, even as they are consistently more conservative. Investors will inevitably perceive that downgrades are likely but that -- in the absence of any methodologies from the SVO -- that the magnitude of those downgrades is largely unpredictable. Worse, this policy will have the effect of handcuffing insurance companies, who will be the only market participants subject to this additional uncertainty and will put them at a competitive disadvantage in the market relative to non-insurance company investors who will not be subject to the same uncertainty and who may confidently rely on the ratings provided by the NRSRO with respect to a given issue.

It should be made clear to regulators that the new proposed language is not a minor change but is instead a major expansion of the authority of the SVO. If a bond is eligible for Filing Exemption, nothing in the current P&P Manual gives the NAIC the power to pick and choose between NAIC-approved Credit Rating Providers ("CRPs") or reject an individual rating by an NAIC-approved CRP.

Under the definition of "*Credit Ratings Eligible for Translation to NAIC Designations*", the current P&P Manual clearly states that *any* credit rating of a security provided by a Credit Ratings Provider with NAIC-approved status for that activity and market "by application of its long-term ratings scale and methodology" (and monitored annually, etc.) "*is entitled to a presumption of convertibility to* ***the equivalent NAIC designation****".* (P&P Manual, Part 2)

Elsewhere in the Manual, there is a confusing definition that purports to be a definition of "Eligible CRP Credit Ratings" but is in fact a clarification of which securities are eligible for Filing Exemption:

> *"**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 that it is not appropriate for NRSRO credit ratings to be used to determine the regulatory treatment of the security or asset);*

The first clause of this sentence simply clarifies that Filing Exemption does not apply to non-Schedule D securities. The second clause permits the SVO to determine, *with regard to a specific security or asset*, that it is not appropriate for "NRSRO credit ratings" (i.e.: Filing Exemption) to be used to determine the regulatory treatment of *[that] security or asset* (although no justification is required for making that determination regarding a given security). That is to say, that a specific security so-designated by the SVO is not eligible for Filing Exemption by *any CRP* and must be filed with the SVO.

However, as stated above, nothing in the current P&P Manual gives the NAIC the power to pick and choose between NAIC-approved CRPs or reject an individual rating by any approved CRP of an otherwise-eligible security. If the current proposed new language is adopted, these sections of the Manual will also have to be rewritten to make it clear that the SVO has been given this new authority to selectively accept or reject individual CRP ratings at its sole discretion. ***This discretion will seriously erode the predictability of the current system which the insurance industry relies on in making investment decisions.***

The proposed new language states that the IAO would be authorized to remove securities from the automatic filing exemption process if it determines that the resulting NAIC designation "does not provide a reasonable assessment of risk *for regulatory purposes*." Presumably those regulatory purposes could only be insuring the solvency of the regulated companies, and we are not aware of any risk other than credit risk which is part of an NAIC Designation[1].

The SVO has identified a small number of securities (43 in total) where its opinion of credit quality differed significantly from the rating provided by the respective CRP -- although without citing any specific flaws in the CRP ratings, or providing its own independent ratings analysis of

[1] * The P&P Manual explicitly states that:

"**NAIC Designations express opinions about credit risk** -- defined as the relative financial capability of an obligor to make the payments contractually promised to a lender." [and that] NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk."

each security. Moreover, our group has not seen any evidence presented that the scale of the problem would justify the potential harm that could be done to capital markets, or that the small number of securities so far identified rises to the level of materiality for capital adequacy or creates solvency concerns for any specific company or group of companies.

Given the potential for significant market disruption, we would suggest an alternative approach focused on specific situations where the issue rises to the level of materiality. This would be to have the SVO/IAO first identify any insurance company with a sufficient number of investments with "questionable" CRP ratings to present possible solvency concerns for the regulators. This information could then be presented to the appropriate regulator or State Commissioner, with suggestions for further action, which could include a more in-depth analysis of that company's investment portfolio. This could be done confidentially without causing major market disruption, and could include the involvement of the NAIC's Financial Analysis Working Group.

This more focused and risk-based approach would be a significantly more efficient use of the SVO's limited staff and resources. It is also consistent with the stated goal of having a 'targeted' approach, and would be less disruptive to markets than having the SVO conduct a review the CRP ratings of thousands of securities -- a "shotgun" process which by its very nature would put a chill on markets.

Finally, any policy to question and potentially overturn CRP credit ratings needs to keep in mind a basic principal, which is that, in advance, there is no such thing as a "correct" credit rating: all opinions about credit risk are just that: opinions. They are predictions about what may or may not happen in the future -- and as Yogi Berra once famously remarked, "Predictions are hard to make; especially about the future."

This being the case, any policy which is finally adopted needs to adhere to certain guidelines:

1.) Any review of an NAIC-approved CRP credit rating needs to be based on a thorough and detailed analysis by the IAO of the specific credit, presented to the investor in a ratings-report format comparable to the ratings rationales required by the SEC of all Nationally Recognized Statistical Ratings Organization. Just as with the NRSROs, that report needs to specify exactly what rating methodologies were used and highlight the specific data and/or conclusions in the CRP report which the IAO disagrees with.
2.) The appeal process needs to be shortened [one to two months at most] and would commence only once the IAO has submitted its full ratings rationale to the investor.
3.) There needs to be an independent third party, *not the IAO itself*, which adjudicates any disagreement about which credit opinion is more valid.
4.) The burden of proof should be on the IAO to refute the credit opinion of the CRP -- by citing specific omissions or conclusions of the CRP -- not on the investor to defend the CRP rating.

Any policy which does not include these basic guidelines will put a serious damper on the capital markets and subject insurance companies to handicaps not faced by other investors, placing them at a serious competitive disadvantage in the marketplace.

The company portfolio-focused approach we propose is practical and implementable and offers specific advantages to regulators and insurers alike while minimizing the downside risks. However, given the potential for significant capital markets disruption, **we hope that the Task Force would agree that the proposed amendments to the P&P Manual warrant much more study and consideration before any policy is implemented.**

Finally, we believe that it is essential that any policy that is ultimately approved -- either based on the language in the current exposure, or modeled on the process we suggest -- be automatically monitored no later than six-months to a year after implementation to be reassessed for its effectiveness, its impact on the insurance industry and the capital markets, and to determine a cost-benefit analysis before making it a permanent policy.

Sincerely,

JMGarrison

John Garrison
On behalf of:
The Lease-Backed Securities Working Group

Copies: Charles Therriault and Denise Genao-Rosado

AI Anderson Insights, LLC

Christopher Anderson, CFA
Principal
322½ East 50th Street
New York, NY 10022-7902
+1 212 753-5791
chris@andersoninsights.com

July 13, 2023

The Valuation of Securities Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Comments, Staff Proposal: 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

Dear Ms. Mears and Task Force Members,

This letter focuses on the governance aspects of the captioned proposal.

Included here are very detailed steps that this task force can take to 1) improve the transparency and functionality of the proposal and 2) enhance its ability to oversee the IAO/SVO if it decides to grant staff the significant new powers it seeks.

How the VOS/TF Could Oversee the IAO/SVO With Respect to This Proposal

Here are six specific elements of a proposal that would facilitate the ability of the VOS/TF oversee the IAO/SVO:

1) <u>Prior to commencing investigations, the IAO/SVO could be required to consult with the VOS/TF or its delegates and obtain its approval for conducting inquiries</u>. The nature of these approvals should be entirely within the jurisdiction of the VOS/TF and could be as broad or limited, as sweeping or specific as the task force judges prudent. This would not necessarily limit "fishing expeditions" by the staff but those would require "fishing licenses" issued by the VOSTF. This would be of significant benefit to the task force because rather than *perhaps* receiving general "summary" reports once a year (on request), the VOS/TF would have real time knowledge of the activities of its staff. This also allows the VOS/TF to "keep score" of how its staff is performing with "hits and misses" on more of a real time basis.

2) <u>The VOSTF could review the methods to be used by the IAO/SVO to determine the "materiality thresholds for analytical review"</u> (¶169 & 170) to assess their validity in judging whether a three notch difference is probable.

3) <u>The VOS/TF could assist the IAO/SVO in gaining access to information it would require to conduct its investigations.</u> Because the NAIC itself is not a regulatory body, the IAO/SVO lacks

the authority to direct insurers to deliver information to it, even if needed to perform its duties. The VOS/TF could accomplish this by requesting that regulators instruct their regulated insurers to provide information about specific securities. By requesting this information the VOS/TF would then have an oversight obligation to assure that IAO/SVO staff members are not improperly using material non-public information delivered to them but this could be managed as is done by NRSROs.

4) The VOS/TF or its designees could specify the periodicity and detail level of reports it requires from the IAO/SVO.

5) The VOS/TF could require that the findings for any investigation by staff meet reasonable standards of justification. In all probability this means that the staff must replicate the work of the rating agency in order to properly evaluate all of the credit positive and credit negative elements of the security so as to be able to determine whether it agrees with the work of the rating agency. If the IAO/SVO is proposing to override rating agency ratings then its work product should be at least to the rating agency standards. Reports by staff should be submitted in the same detail and to the same standards as for "rating rationales" prepared by rating agencies. This explicitly requires the disclosure of specific rating methodologies and explanations of how those have been applied.

6) The VOS/TF could develop a review or appeal process, accessible to insurers, to make it more transparent and accountable than is currently proposed. By monitoring the results of these appeals the task force would gain key insights into the performance of the IAO/SVO.

Delegation of Authority, Not Responsibility

There should be no doubt as to who is responsible for overseeing the conduct and performance of the IAO/SVO[1]. These employees are delegated a great deal of legally enforceable power but they are not directly subject to the control of any actual governmental body. Authority is granted to staff by the VOS/TF when it approves the manual for the IAO/SVO. This delegation of power is, in turn, authorized at higher levels by the Financial Condition (E) Committee and ultimately by the NAIC's Plenary as those entities approve of the work of this task force and other NAIC entities.

One of the first things I learned as a young infantry officer is that while authority can be delegated, as is proposed here, responsibility cannot be. By this principle, the responsibility for the conduct and performance of the IAO/SVO to act according to its manual of instructions continues to rest with the entities that grant those powers. The VOS/TF is at the first level of responsibility for oversight. NAIC management certainly has administrative control over its staff in many respects but when it comes to the execution of its duties specified in its manual then continued responsibility rests with the entity that confers those powers -- this task force.

[1] "2023 Adopted Charges The Valuation (E) [*sic*] Securities (E) Task Force will: 1) Review and monitor the operations of the NAIC Securities Valuation Office (SVO) and the NAIC Structured Securities Group (SSG) to ensure they continue to reflect regulatory objectives…." https://content.naic.org/cmte_e_vos.htm

Overseeing the IAO/SVO with Respect to this Proposal

In the past the VOS/TF appointed a special entity to assist it in fulfilling its responsibility of overseeing the SVO. That was the SVO Oversight Working Group and it was directly accountable to the task force itself. Today nearly half of all NAIC members sit on the task force, but it is a very unusual position of having no working or study groups reporting to it. This contrasts with prior years where there were as many as three supporting entities.

As to oversight, the staff proposal contains a single provision:

> ¶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.

This provision does not even begin to approach acceptable levels of governance given the significant additional powers staff is requesting. It is even startling because while it says the VOS/TF *may* make requests it does not require the Directors to actually do anything. This is analogous to employees telling their managers that management *may* ask for a summary of activities once a year. Clearly this version of the staff proposal does not contemplate any significant level of oversight.

Fortunately it is not the staff that decides how its work is to be overseen. For the staff the manual is its basis for authority and it is both limiting and binding. That same manual certainly does not and cannot constrain or limit the oversight activities of the VOS/TF. The task force is free to provide for more specific and detailed accountability.

A Precedent for Gaining Information Concerning Performance

In the past the SEC confronted a situation similar to what the VOS/TF faces today. In that instance the SEC needed to determine how the public could gain insights concerning the conduct and performance of rating agencies. Now the question faced by the VOS/TF is how it can gain sufficient insights to fulfill its oversight responsibilities. The actions taken by the SEC can provide a template for the NAIC as they essentially answer the same question.

After the public outcry and severe criticism of their Nationally Recognized Statistical Ratings Organizations during and after the financial crisis of 2007 –'08 the SEC acted forcefully. Prior to that time it is my understanding that NRSROs were granted "no action letters" to recognize their status but there was not much more to it than that. The SEC reacted to the crisis by imposing significant requirements in order to fulfil its mission to "….protect investors and ensure the integrity of the rating process, including through the office's oversight of Nationally Recognized Statistical Rating Organizations[2]" These include, among many other requirements:

- Mandating the public disclosure of rating methodologies

[2] https://www.sec.gov/news/press-release/2023-21

- Requiring the preparation of rating rationales explaining how the methodologies were applied for each rating
- Conducting examinations to determine whether NRSROs were complying with their published procedures
- Specifying that rating agencies can only act as NRSROs for assets in the five asset classes for which they were specifically registered with the SEC and
- Publishing a report each year which "…summarizes the findings from our annual examinations and also provides information about NRSROs, their credit ratings businesses, and the industry more broadly."

The SEC also requires each NRSRO to publish on its websites standardized information in what is called the "Form NRSRO". The form includes these exhibits:

- Performance Measurement Statistics
- Procedures and Methodologies Used to Determine Credit Ratings
- Policies and Procedures to Prevent the Misuse of Material Nonpublic Information
- Organizational Structure
- Code of Ethics
- Conflicts of Interest Related to the Issuance of Credit Ratings
- Policies and Procedures to Manage Conflicts of Interest
- Information Regarding Credit Analysts and Credit Analyst Supervisors and
- Information Regarding Designated Compliance Officer

In short, these are just some of the steps SEC has taken to provide information to members of the public with the goal of allowing them to develop informed opinions of rating agency performance so they would not have to rely blindly on the NRSROs.

The VOS/TF can use these same tools now to meet its oversight obligations. This precedent shows in specific concrete terms, what it takes to understand the performance of a rating agency. The SEC's purpose was to inform the public. The VOS/TF's need now is to inform itself.

How to Move Forward

Concerning this staff proposal that it be granted significant new power, it is not very likely that this 26-member VOS/TF, with its existing resources and acting by itself as an undivided whole, will be able to effectively oversee the IAO/SVO. Here are some things that can be done to accomplish that --

Specific Recommendations:

<u>Reappoint a working group to oversee the performance of the IAO/SVO</u>. That working group would have appropriate charges and report to the VOS/TF

<u>Reappoint a second working group to consider and prioritize efforts concerning existing and developing investment risks</u>. Previously such a group was called the Invested Asset Working Group. Hopefully this would eliminate some of the pressure on the VOS/FT to create *ad hoc* groups in the future

Retain outside professional, independent, investment risk expertise. Obviously this is essential to create a meaningful appeal process that is a part of this proposal.

One Additional Possibility -- Time for a Ground-Up Reappraisal to Reimagine How the NAIC Can Meet the Needs of Regulators Examining Insurer Investments

Given the potential difficulty of overseeing staff activities in the existing structure perhaps it is time to reconsider whether there are better ways the NAIC can meet the needs of regulators than it has been using for past decades.

This is not unprecedented. In the past the NAIC has retained outside consultants to advise on how best to evaluate insurer assets. Long ago the NAIC retained KPMG Peat Marwick which prepared 35-page report[3] on the performance of the SVO. That report was not released to the public but those task force members who have never seen it could benefit from reviewing it and considering the ideas for improvements it contains. A more recent study by Oliver Wyman was also not released but that, too, may contain useful information and ideas.

So there have been two extensive studies in the last 25 years, but the most recent one I know of was done years ago. Given that, it may well be time now to commission a new, independent and comprehensive review.

There should be no preconceived notions. It may or may not be that the bond-by-bond analysis process that has been in place for decades now can be improved upon. Rather than seeking minor fixes or incremental improvements perhaps it is time to consider whether it would be beneficial to build new capabilities from scratch to best meet the needs of today and the future.

This task force alone cannot commission such a sweeping review but it certainly can recommend and provide justification for it.

Summary

The proposal could be revised, as suggested, to improve its processes and transparency. This would have the added benefit of giving the VOS/TF greater insight into staff activities and would improve the accountability of the staff to the task force. Governance and oversight could also be improved by requiring the compilation and release of information similar to what the SEC requires of the rating agencies it regulates, also as specified above.

Hopefully even as these steps could improve governance they might also have the benefit of reducing reduce the likelihood and perhaps the severity of possible market disruptions. Given the extent of the powers being proposed this is not an idle fear. To paraphrase a paper published by the NAIC and jointly edited by a then past president and later CEO of the NAIC, “when the insurance regulators sneeze the markets can catch a cold”.[4] Ideally, with oversight and transparency, it might be possible to prevent even sniffles.

[3] “Report on Due Diligence Practices and Procedures of the Securities Valuation Office” June 1998
[4] Finnerty, J, Kwan, M, (2007) When the Insurance Regulators Sneeze , The Hybrid Market Can Catch a Col*d, Journal of Financial Regulation*, NAIC 6

It may also be time for the NAIC to conduct a bottom-up review of what regulators actually need as they review the investments of insurers and how the NAIC can meet those needs, putting everything on the table to seek the best result.

Copies: For the VOS/TF: Charles Therriault and Denise Genao-Rosado

This is in furtherance to the discussions held on this topic at the VOSTF meeting held on Monday, May 15, 2023.

I am Marty Carus, President of Martin Carus Consulting LLC, I have been working in the insurance industry since 1965, first as a regulator for 34 years and as Chief Examiner with the New York Insurance Department (now merged into the New York Department of Financial Services). As a regulator, I heavily participated in NAIC activities and chaired or co-chaired the VOSTF (as well as several other NAIC groups) on several occasions. Subsequently, I worked 15 years for a major insurer group and represented that group at several NAIC meetings as well as at the IAIS. I now am a consultant but I am expressing the following comments as a consumer/policyholder of various and several insurance products, an investor in insurance companies as well as other entities that either themselves invest in insurers or are to a degree reliant on insurance to conduct their businesses and last but not least of all, as a taxpayer. I note that this proposal, like almost all other NAIC proposals, does not in any way define its associated costs which are substantial and are ultimately borne by either policyholders as any of such regulatory costs are passed along through premiums or annuity considerations; or by investors since such costs not ultimately borne by consumers, lower income of insurers and thus adversely impact their capital suppliers either through lower dividends or lower performance which translates into lower stock prices and thus lower rewards for capital suppliers. These deleterious impacts could be offset by benefits to the named constituencies; however, the proposal includes no calculation, nor even an estimate, of any benefits associated with the proposal. How can that be? If an insurance entity operated that way it is likely that regulators would be aghast at such poor business practices and poor enterprise risk management procedures. Moreover, as a taxpayer, I am aghast that the governments I pay for operate in such a manner. Noting that any benefit from a new regulatory procedure can be cast as protecting consumers from operational harm, I also note that there is no *estimate,* at least, of any specific quantifiable enhancement of the solvency oversight function conducted by regulators. At least, with such a calculation of benefit, one could compare that with the dollar cost of the new proposal to determine whether the proposal, or any proposal, is worth the cost net, of course, of the protections afforded policyholders, beneficiaries and claimants through guaranty funds. As a member of each of the constituencies noted above, I would expect that be the pro forma operational paradigm for crafting proposals, especially this specific one. Perhaps you can answer why this wasn't done in this instance or is not the general procedure of the NAIC.

It is well established that the staff of the investment arms of the NAIC has not been fond (to put it mildly) of the Filing Exempt ("FE") process put into effect decades ago. It seems to me that this is a first attempt to overturn a process that has worked extremely efficiently and at low cost for decades. Also, there has not been a major market participant that has encountered a severe adverse market event/insolvency in decades and I cannot remember any insurer's risk-based capital being materially understated due to its investment operations. It seems there was a single instance of a company, a minor market player indeed, having gone under but there was massive fraud involved in that situation. (Note: I define a major market participant as an insurer with even as much as 1% market share but I firmly believe you could reduce that considerably below even 1% and the results would be the same.)

This leads to the following questions:

1. Why is this proposal being made at this time if at all?
2. Why is there no materiality threshold included in the proposal?
3. What specific conditions have arisen that suddenly make this proposal necessary?
4. Has the insurance industry experienced a financial strength decline due to its investment operations outside of the normal investment market variations that result from cyclical overall economic conditions?
5. Are there examples of companies abusing the FE process to the extent that its RBC calculations were materially misstated to somewhat hide an adverse financial condition requiring regulatory intervention?
6. Is the current solvency regulatory regime "good enough as is?"

What are the answers to these questions?

Perhaps most notably, nothing in the proposal indicates any consideration of possible unintended consequences which could arise from implementing this proposal. Insurers conduct their investment operations needing at least some semblance of regulatory certainty on a time-sensitive basis. Making investment decisions are not open-ended as to timing. They employ, in the aggregate, thousands of investment professionals to engage in investments operations or rely on outside sources which employ such professionals. They also interact, closely with regard to private placements, with rating agencies which, in turn employ thousands of credentialed investment professionals. Thus, the FE process allows companies to be able to determine the regulatory capital needed to support its investments *at the time decision-making for an investment has to be made*. Retrospective Monday morning quarterbacking second guessing investment decisions can make for severe market dislocations and cause insurers to shy away from making *appropriate risk-weighted investment decisions* in fear of having their decisions being arbitrarily overridden by an almost non-existent staff at the NAIC employing non-transparent procedures. As a consumer trying to be prudent in choosing companies to which I wish to do business with, or as an investor choosing which insurer to invest in, am I supposed to rely on a small staff of people unfamiliar and perhaps uncredentialed to deal with complex investments or rely on companies having much larger professional staffs and possessing a track record of *proven* performance. From past experience when there have been dislocations of the investment market due to regulatory miscalculations (e.g., relative to “debt/equity hybrids” and “trust preferreds” where bond treatment was disallowed severely disrupting the market and then subsequently reversed due to the widespread recognition of the unintended consequences of the initial decisions), I don’t see the case for regulatory meddling with the current system which has been shown to have worked just fine. In short, the proposal seems to represent a solution to a non-apparent, non-defined problem. If a single investment’s rating for RBC purposes seems awry but is immaterial as to an entity’s overall RBC, so what?

Before continuing to incur cost and until a solid case can be made on a cost/benefit basis and in consideration of answers to the questions included above herein, this proposal should be withdrawn.

Marty Carus
President of Martin Carus Consulting LLC

Genworth

Genworth Financial, Inc.
3001 Summer Street
Fourth Floor
Stamford, Connecticut 06905
203 708.3300
genworth.com

July 13, 2023

Ms. Carrie Mears, Chair
Valuation of Securities Task Force (VOSTF)
National Association of Insurance Commissioners (NAIC)
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Practices & Procedures (P&P) Manual Amendment Authorizing the Procedures for the Securities Valuation Office's (SVO's) Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears:

Thank you for the opportunity to comment on the above-referenced exposure. While we appreciate the potential issues the SVO wishes to address through the proposed amendment, we have some concerns which we discuss in this letter.

The proposed language provides the SVO with the means and processes to take actions that we believe will benefit policyholders in the long run. Nevertheless, the proposed framing and implementation of these processes leave us with concerns relating to process transparency, industry interaction with the SVO and sufficiency of SVO resources, and potential disruption to industry deal flow.

We have summarized below our concerns with the proposed framework and process and provide recommendations that we believe will enhance the SVO's role in working with industry participants around these issues.

Concerns

A ratings challenge from the NAIC staff may be based on only the limited information provided by the CRP. The lack of more extensive material that the insurer might provide to the SVO in an initial filing could result in ratings changes or challenges based on incomplete information.

Without disclosure of the SVO's reasoning behind a changed rating, investors may not be able to understand the SVO's specific exceptions to the CRP rating or methodology in question. This could lead to investor and issuer uncertainty and could result in a negative effect on market issuance.

Investors understand that it is of paramount importance that the SVO have the resources necessary to undertake the processes proposed. To the extent the SVO lacks such resources, investors want to have confidence they could look to the NAIC to address SVO needs.

Genworth

Potential solutions

Transparency and fulsome disclosure from the SVO as to its judgment around CRP ratings would address concerns regarding investor knowledge and market uncertainty.

The SVO should publicly identify rating agency methodologies with which they have an issue and describe in detail the basis for any challenge. Similarly, the SVO should lay out the rationale for its designation of a security whose rating it is changing.

As part of this process, and in order to reduce designation uncertainty over time, the SVO should be available for direct discussion of its analysis and conclusions with interested members of industry.

VOSTF could ensure the SVO has adequate resources to carry out the processes envisioned by requiring any challenges to a CRP methodology and any proposed ratings changes to be presented to VOSTF for approval.

Thank you for your time and attention to this matter. Please feel to contact Michael Shepherd at michael.shepherd@genworth.com or (203) 708-3324 with any questions or comments.

Very truly yours,

Genworth Financial, Inc.

By: Kelly S
Kelly A. Saltzgaber
EVP and Chief Investment Officer

NAMIC®
NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

317.875.5250 | [F] 317.879.8408
3601 Vincennes Road, Indianapolis, Indiana 46268

202.628.1558 | [F] 202.628.1601
20 F Street N.W., Suite 510 | Washington, D.C. 20001

July 13, 2023

Carrie Mears, Chair
Valuation of Securities (E) Task Force
National Association of Insurance Commissioners
c/o Charles Terriault and Denise Genao
Via Email: ctherriault@naic.org and dgenao1@naic.org

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

Dear Ms. Mears,

Thank you for the opportunity to comment on the 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 (Exposure), which is intended to provide the Valuation of Securities Task Force ("VOS/TF") with better visibility into the methodology and impact of both public and private credit ratings as well as the ability to change the filing exempt (FE) designation if deemed appropriate. The following is submitted on behalf of the member companies of the National Association of Mutual Insurance Companies (NAMIC).

NAMIC has more than 1,500-member companies representing 40 percent of the total U.S. property/casualty insurance market. NAMIC member companies serve more than 170 million policyholders and write more than $323 billion in annual premiums. Our members' direct written premiums account for 67 percent of homeowners' insurance and 55 percent of automobile insurance. Through NAMIC advocacy programs it promotes public policy solutions that benefit NAMIC member companies and the policyholders they serve and fosters greater understanding and recognition of the unique alignment of interests between management and policyholders of mutual companies.

NAMIC appreciates the SVO's goal of ensuring greater consistency, uniformity, and appropriateness to achieve appropriate financial solvency objectives and balancing that goal against the risk of blind reliance on credit ratings. However, NAMIC has some concerns surrounding the processes as listed in the Exposure.

Transparency in reasoning, standards, and the materiality threshold would allow companies to know why securities are flagged and the three-notch difference between the Eligible NAIC CRP Credit Rating and the Insurance Analysis Office's (IAO) assessment. The Exposure provides limited insight into the process; it is unclear why a security would be placed under analytical review of IAO or if there are asset classes that will typically be flagged. Paragraphs 169-170 of the Exposure give some observable factors but there is still little knowledge of the IAO's process. What are the materiality threshold references in the Exposure and are there certain characteristics that would flag one FE security for review over another? The Exposure states that the IAO may ask for additional data and documentation may be requested to conduct the review. Are there examples of said data and documentation that can be provided? Will there be any fees associated with this IAO review?

The Exposure states that the IAO may deem an entire security class ineligible for the filing exemption designation, but it does not provide any metrics or standards for doing so. If an entire security class is deemed ineligible for filing exemption, the IAO should publish its reasoning in addition to giving timely and prompt notice to insurers. It is unclear if there will be an appeal process or a dialogue for a class determination or if the appeal process only exists at the individual insurance company level.

In addition, there is uncertainty around the appeal process. As the Exposure is written, VOS/TF would have the ability to change a FE rating for any reason and there is not a clear review path. For example, what types of materials would need to be presented for the review? How would an insurance company request an appeal and is the appeal with the IAO staff or the relevant regulator? What is the time frame from revocation of the FE eligibility to providing a full filing of the security? How do other rating agencies opinions on a security, if any, weigh into the IAO process?

The P&P Manual is currently incredibly long and represents the documentation of a very complicated process, built up over the years, to serve both regulators and industry. While NAMIC does understand the VOS's duty to provide information to the regulators' regulating financial solvency and is supportive of that goal, the current Exposure has too much uncertainty and lacks transparency. NAMIC appreciates the benefit of a shared understanding of standards, thresholds, and process between supervisors/regulators and the industry and NAMIC looks forward to the continuing dialogue.

Thank you,

Colleen Scheele

Colleen W. Scheele, Public Policy Counsel and Director of Financial and Tax Policy
National Association of Mutual Insurance Companies

PIPER | SANDLER

1 GREENWICH PLAZA, 1ST FLOOR
GREENWICH, CT 06830
P 203 861-7600
Piper Sandler & Co.
Since 1895. Member SIPC and NYSE.

July 13, 2023

Ms. Carrie Mears, Chair
Valuation of Securities Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197
Via email: ctherriault@naic.org and dgenaorosado@naic.org

Re: P&P Manual Amendment Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears,

As the market leader for Kroll and Egan-Jones rated debt issuances for financial institutions, we wanted to inform you that the current NAIC proposals have already caused a major market disruption as word of the pending proposals permeate all levels of the insurance industry. As a result, an increasing number of insurance companies have instituted a moratorium on purchasing all Kroll and Egan-Jones rated transactions in these markets. Prior to buying a particular transaction, insurance companies need to know what the NAIC designation will be in order to monitor their regulatory capital charges. By keeping these insurance companies on the sidelines, they have now been put at an enormous disadvantage versus the entire institutional investor universe. Additionally, this has materially impaired capital markets access for a multitude of high quality, small to mid-sized issuers spanning the financial institutions marketplace given the absence of insurance company investors.

Since 2014, there have been approximately 438 Kroll and Egan-Jones Rated Regional and Community Bank debt transactions totaling $29.9 Billion[1] and 114 Kroll and Egan-Jones Rated Non-Bank Financial debt transactions totaling $8.9 Billion[2] covering REIT, insurance, asset manager, broker-dealer, specialty finance and other real estate related companies in both the public and private debt capital markets. The emergence of the Kroll and Egan-Jones bond rating agencies has been critical in helping to establish this burgeoning national corporate debt market following the Great Financial Crisis. These transactions have been sound investments for the insurance companies enabling them to earn strong risk-adjusted returns.

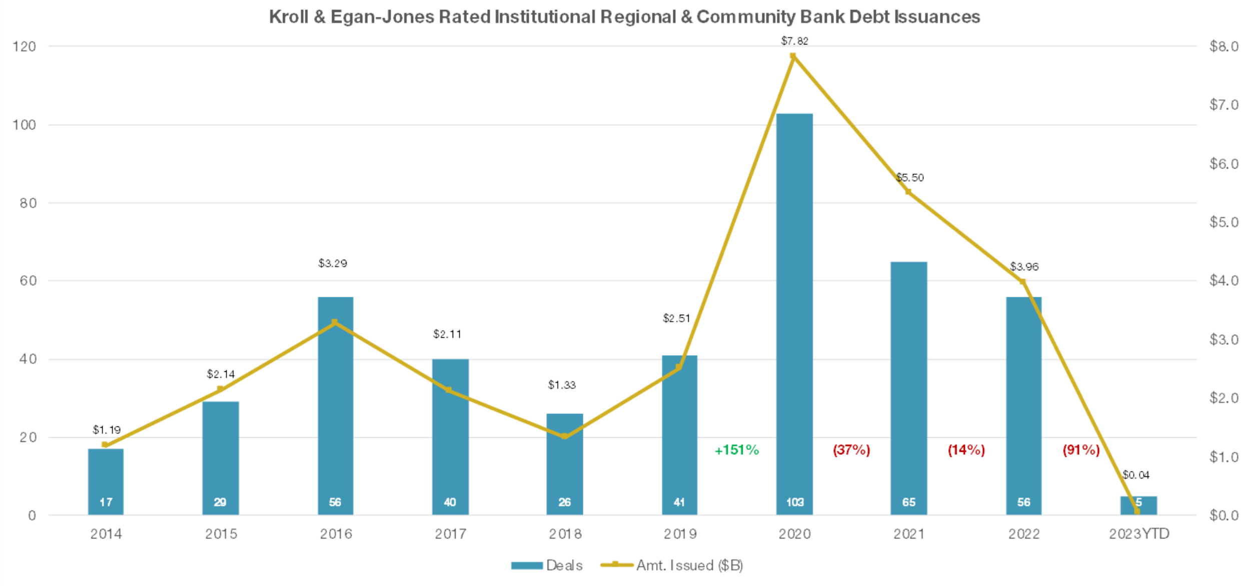
In 2020/2021, when the onset of COVID-19 shut down the credit markets for a period of time, Kroll and Egan-Jones rated institutional bank and non-bank transactions grew to record high volumes following the Federal Reserve's implementation of multiple national stimulus packages. Beginning in 2022, the market for Kroll and Egan-Jones rated bank and non-bank financial debt started to significantly drop off in both total number of deals and respective transaction sizes. This was partially due to deteriorating market conditions, however, the NAIC's negative bias towards the smaller rating agencies also materially impacted insurance investors' willingness to invest in bank and non-bank financial debt transactions. As an increasing number of insurance company investors have learned of the proposed NAIC/SVO's intent to unilaterally assign high credit risk designations to Filing-Exempt securities, the market has come to a virtual halt, denying many strong and viable companies the ability to raise capital. Furthermore, this action, if ever implemented, would immediately cause affected securities to lose value and cause mark-to-market losses for all insurance companies and severely harm the U.S. insurance industry.

[1] Includes both Piper Sandler and all Wall Street underwriters
[2] Total represents only Piper Sandler issuances

Kroll & Egan-Jones Corporate Bond Volumes

Kroll & Egan-Jones Rated Institutional Regional & Community Bank Debt Issuances

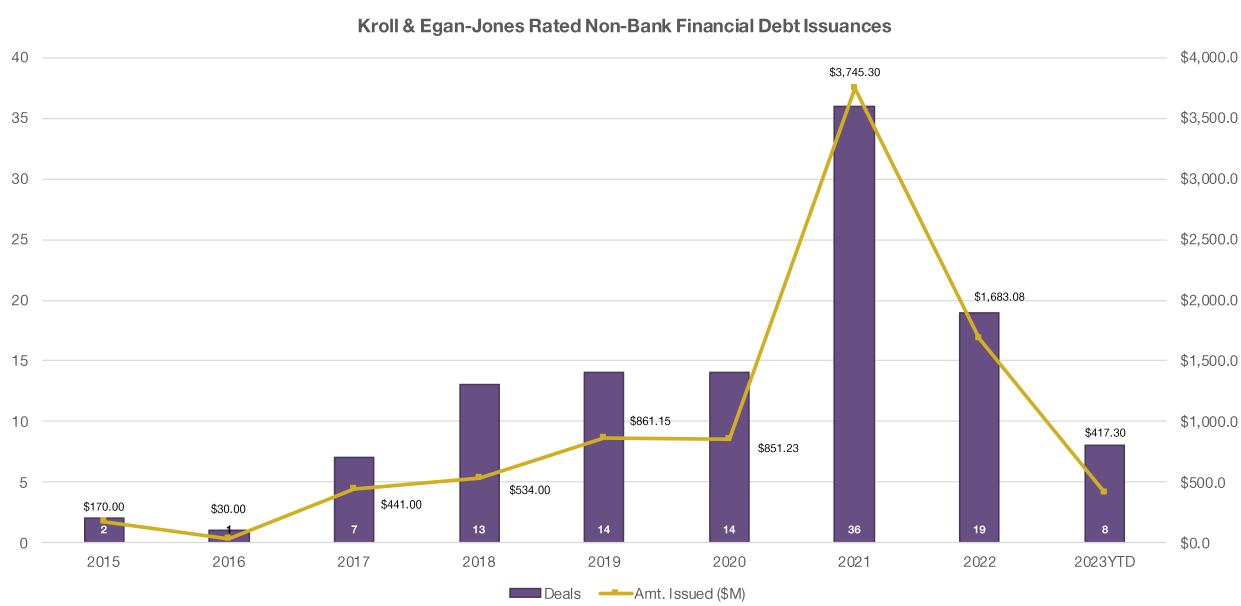
2014 – 2023YTD: 438 Deals for $29.9 Billion



Note: Deal count includes $1000 par subordinated debt and senior note offerings for Community Banks; Community Banks defined as banks or bank holding companies with less than $65 billion in assets rated by Kroll and/or Egan-Jones; Deal count does not include offerings for Community Banks with over $65 billion in assets at the time for the transaction; Excludes transactions less than $5 million in offering size
Source: S&P Global Market Intelligence, Bloomberg, Piper Sandler Syndicate Desk

Piper Sandler Kroll & Egan-Jones Rated Non-Bank Financial Debt Issuances

2015 – 2023YTD: 114 Deals for $8.87 Billion



Source: S&P Global Market Intelligence, Bloomberg, Piper Sandler Syndicate Desk

It should be noted that of the 552 financial services transactions depicted above, only one issuer has gone into default (First NBC Bank Holding Co. which issued $59.3mm of Kroll-rated BBB- subordinated notes in 2017). This implies an extremely low default rate of only 0.18%. By contrast, SVB Financial (Moody's: Baa1 / S&P: BBB-), Signature Bank (Moody's: Baa2 / Fitch: BBB) and First Republic Bank (Moody's: Baa1 / S&P: A- / Fitch: A-) all failed this spring and each of the three banks were rated by Moody's, S&P and/or Fitch.

We, similar to many market participants, do not believe the NAIC / SVO has the required resources, analytical capability or regulatory status (i.e., not an SEC regulated NRSRO) to unilaterally implement unexpectedly high credit risk designations to select transactions without the necessary transparency or rationale. Since this market was initiated in 2014, our insurance clients have always carried out intense due diligence on all corporate credits that have successfully come to market. Both Kroll and Egan-Jones, as SEC regulated NRSROs, allocate exhaustive resources and manpower to analyze these issuers and carry out multiple phone calls to directly interact with the respective management teams. The credits are monitored throughout the year and through the annual surveillance process the ratings are affirmed with updated rating reports that include a ratings rationale. Both Kroll and Egan-Jones have developed long tenured and proven rating methodologies, all of which are furnished to the NAIC/SVO via their stability and transition reports.

The other important development in this market that has come to be of immense value to our insurance company buyers is the number and frequency of acquisitions that have occurred over the years resulting in substantial upgrades in many instances. We have witnessed more than 50 mergers and acquisition transactions involving our Kroll and Egan-Jones rated issuers which have resulted in many issuers being acquired by much larger corporations that have had ratings from the largest rating agencies. The increased value of their acquired investments boosts the performance and credit quality of their overall investment portfolios. The issuers in our space tend to be smaller and more niche oriented within their industries, which leads to a higher probability for merger and acquisition activity which in turn has improved credit quality and stronger ratings. In fact, just this month we have witnessed the most recent example of this trend in the REIT sector as Ellington Financial (EJR: A) has announced a merger with Great Ajax Corp (EJR: BBB), which will result in a much larger, more highly rated security for the holders of Great Ajax's $110mm 8.875% senior notes that were issued in August 2022.

In conclusion, since the Great Financial Crisis this active corner of the corporate debt market has enabled hundreds of corporations to successfully raise attractive financing while effectively serving the investment portfolio needs of the U.S. insurance industry. Both Kroll and Egan-Jones have successfully fulfilled their mission as well-respected SEC regulated NRSROs in providing ratings to this sector of the financial services industry. The fact that the number of defaults or impairments have been negligible only supports insurance investors' view of the important role that these rating agencies play in the debt capital markets. Investors greatly benefit from enhanced competition and methodological differentiation amongst what is a finite group of SEC regulated NRSROs. As long as these new proposals hang over the marketplace, the ability of these smaller corporations to raise capital and provide strong, value-added investments for the insurance industry will be irrevocably harmed.

I am available to discuss at your convenience and can be reached at: +1 (203) 861-7643 or email: jacques.desaintphalle@psc.com.

Sincerely,

Jacques de Saint Phalle

Jacques de Saint Phalle
Piper Sandler & Co.
Head of Debt Capital Markets/Syndicate

Jacques de Saint Phalle is the head of the Fixed Income Capital Markets and Syndicate Group at Piper Sandler. Previously, he was a principal of Sandler O'Neill + Partners, L.P. where he focused on executing fixed income and private equity capital raises for financial institutions. He has formed deep and extensive relationships with investors in his 38 years of capital markets experience. Prior to joining Sandler O'Neill in 2007, de Saint Phalle was a managing director in the structured finance group at FTN Financial and before that, fixed-income syndicate manager at Keefe, Bruyette & Woods, Inc. He was one of the key senior executives hired to help rebuild KBW after the firm suffered significant losses in the terrorist attacks of September 11, 2001. Prior to KBW, de Saint Phalle was global syndicate manager of Bear Stearns' fixed income corporate bond department. He joined Bankers Trust in 1993 to build its corporate bond unit. In 1989 he established the corporate bond department at Citicorp after the Federal Reserve granted securities underwriting powers to the U.S. money center banks. de Saint Phalle spent three years at Rensselaer Polytechnic Institute and holds a bachelor's degree from the University of Wisconsin-Madison. He played Division 1 hockey at both institutions and was a member of Wisconsin's NCAA Division I Championship team in 1983.

Shawnda Martin
Regulatory Policy Director & Associate General Counsel
Regulatory Affairs

601 13th St NW
Washington, DC 20005
T: 919.749.6913
E: shawnda.martin@tiaa.org

Filed via Electronic Mail

June 22, 2023

Carrie Mears
NAIC Valuation of Securities Task Force

Re: Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Through the Filing Exemption Process

Dear Ms. Mears:

Teachers Insurance and Annuity Association of America ("TIAA") appreciates the opportunity to provide comments on the Valuation of Securities Task Force's proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* ("P&P Manual") regarding the procedures for the Security Valuation Office's ("SVO") discretion over the National Association of Insurance Commissioners ("NAIC") designations assigned through the filing exemption ("FE") process. Following the NAIC's Spring National meeting, the Valuation of Securities Task Force ("Task Force") requested that the SVO staff develop a process to challenge a NAIC Designation assigned from a credit rating provider ("CRP") in the FE process that the SVO does not consider to be a reasonable assessment of risk for regulatory purposes. We understand that the stated purpose of the proposed amendment is to grant the SVO discretion over the assignment of NAIC designations for securities subject to the FE process to ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives. Although we appreciate the objective and purpose, TIAA has concerns with regard to two of the proposed updates, which we believe are problematic for the entire industry. We discuss our concerns below.

I. <u>About TIAA</u>.

Founded in 1918, TIAA is the leading provider of retirement services for those in the not-for-profit space including the academic, research, medical, and cultural fields. Over our century-long history, TIAA's mission has always been to aid and strengthen the institutions, retirement plan participants, and retail customers we serve and to provide financial products that meet their needs. With our strong not-for-profit heritage, we remain committed to the mission we embarked on in 1918 of serving the financial needs of those who serve the greater good.

To carry out this mission, we have evolved to include a range of financial services, including asset management services offered by our subsidiaries. TIAA has $1.3 trillion in assets under management, and our investment model and long-term approach aim to benefit the 5 million retirement plan participants we serve across more than 15,000 institutions.[1]

II. <u>The proposed amendment would provide the SVO with authority that would have unintended consequences</u>.

As stated above, TIAA understands the intent of the proposed amendment to grant the SVO discretion over the assignment of NAIC designations for securities subject to the FE process. The proposed amendment sets forth criteria that would authorize the SVO to challenge an FE calculated NAIC designation. The proposed criteria includes:

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

In formulating our comments, TIAA has carefully considered the exposure draft and its implications. Overall, our concerns are focused on proposed Sections 81 and 170, which we believe are problematic for the entire industry:

1. <u>Section 81 is amended to include the following provision:</u>

"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 Investment Analysis Office ("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."

[1] As of June 30, 2021

2. **<u>Section 170 is amended to add the following language to the P&P Manual:</u>**

"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."

TIAA is concerned that these sections provide the SVO with the authority to override the rating of any FE security for which it disagrees, for any reason. Per review of the exposure, there does not appear to be a process that requires the SVO to submit its own rating analysis for the investor to review, or a process that describes why an FE rating was rejected. This creates uncertainty within the market regarding how FE securities will be treated, and the lack of transparency and consistency used within the rating process.

Furthermore, the factors proposed above do not provide consistency of application. The first suggested method, a comparison to peers rated by different CRPs, has historically been an unproven method. This method was initially proposed on November 29, 2021, by the SVO to the VOSTF whereby the SVO challenged the ratings of 43 securities using this method. A subsequent ad-hoc group was formed by VOSTF to evaluate the effectiveness of the SVO's use of the proposed method and VOSTF severely questioned the overall rationale and never ratified or deemed it reliable. Since this proposed method has previously been considered and not endorsed by VOSTF, we suggest that VOSTF remove Section 80 from the proposed amendment.

The second suggested method of using yield to determine credit risk is also unreliable given that market yield differentials do not exclusively reflect creditworthiness. This is because market yield incorporates other risk factors such as liquidity, novelty, and market factors (public vs. private) that cannot be used to assess the validity of credit ratings. Lastly, the IAO's assessment of applying available methodologies is problematic as such methodologies are unspecified and investors do not have a transparent view of how the SVO is rating such securities.

TIAA recommends that a clear methodology be outlined if the SVO is given authority to override certain FE security ratings, as this would provide clarity and ensure fairness in the market. Other safeguards are currently in place that provide support for FE ratings. All FE rated securities have a rating analysis associated with it from a nationally recognized statistical ratings organization (NRSRO) that includes the NRSRO's methodology. The SEC closely regulates all nine of the NRSROs and tracks, in detail, their historical performance, allowing investors to evaluate the quality of their ratings. In addition, all NRSROs are required to provide publicly available detailed methodologies for each type of investment they rate.

III. **Conclusion**.

We appreciate the opportunity to comment on this important issue. We stand ready to help discuss this proposed amendment broadly across the industry and to work with the VOSTF and SVO to resolve any operational questions or challenges. We hope the comments that we have provided here are helpful and we welcome further discussion on any of the points in this letter.

Sincerely,

Shawnda Martin

Shawnda Martin

July 5, 2023

Ms. Carrie Mears, Chair
Valuation of Securities Task Force (VOSTF)
National Association of Insurance Commissioners (NAIC)
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Practices & Procedures (P&P) Manual Amendment Authorizing the Procedures for the Securities Valuation Office's (SVO's) Discretion Over NAIC Designations Assigned Through the Filing Exemption Process

Dear Ms. Mears:

We are writing this letter to express our concerns with the proposed amendment referenced above in the subject line. It is our belief that this amendment will have significant negative consequences on private placement market activity and meaningfully impact the ability for private capital to participate in the market.

We would like to note the following considerations:

- Credit rating agencies have detailed and transparent criteria for rating debt products which allows for structuring credit to achieve target ratings with a measure of predictability once rated. These rating agencies have all been approved as NSRO's by the NAIC due to comfort in their rating methodology and track record over time. If the ultimate rating adopted by the SVO can be different from CRP assigned ratings, the ratings outcome uncertainty will make it near impossible to design structures that have predictable outcomes, which is a cornerstone for the private placement market
- The added uncertainty for insurance companies will impact their desire to invest in credit, likely resulting in smaller orders, increased pricing or move to other asset classes. Should this occur, it will impact a vital source of longer term capital for many companies
- Adoption of this proposal would set a precedent and make it appear more likely that additional future negative amendments may be adopted, further increasing the riskiness of investing in private placements

Based on these concerns we strongly recommend that the proposed amendment not be adopted in order to preserve the efficient and smooth workings of the private placement market.

Vlad Delic, Director
BMO Capital Markets Corp.

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

July 14, 2023

Ms. Carrie Mears, Chair
Valuation of Securities Task Force (VOSTF)
National Association of Insurance Commissioners (NAIC)
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Proposed Amendment to Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) Amendment Authorizing the Procedures for SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process (memorandum dated April 25, 2023, with proposals and Securities Valuation Office (SVO) staff recommendations)

Dear Ms. Mears:

On behalf of the insurance company members of the Group 1001 insurance holding company system, we appreciate the opportunity to comment on the proposed amendment to the P&P Manual included in the above-referenced memorandum. We have concerns with the current proposal and its probable impact upon capital markets and insurers. As of year-end 2022, privately rated assets accounted for ~44% of insurance companies' bond portfolios according to a publication by ALIRT Insurance Research. The proposal, as currently written, creates significant uncertainty with respect to existing insurance company investments and future market transactions. Uncertainty can lead to the mispricing of assets, illiquidity, inefficient markets, and decision making that is not in the long-term or short-term interests of insurance companies or their policy holders.

We think alternative solutions should be considered and studied to avoid significant disruption to the capital markets and respectfully request that the NAIC and SVO provide industry with additional transparency regarding their concerns. It is unclear whether the proposal is intended to address rating methodology, differences of opinion, or target certain asset types or structures. An issue paper containing specific examples, quantitative analysis, and documented areas of concerns would enable industry and NAIC staff to collaborate to address the NAIC's specific concerns. Moreover, the contemplated scope of the proposal is simply too broad. It would not provide insurers any level of certainty as to whether assets will remain filing exempt if they meet certain criteria (e.g., do not have any 'red flags').

As you are aware, bespoke securities and private assets became a focus for the SVO and the Structured Securities Group (SSG) in 2019. Since then, the VOSTF adopted procedures to gain additional transparency from industry with respect to individual assets. Most notably, insurers

10555 Group 1001 Way
Zionsville, IN 46077

group1001.com

are now required to file rating rationale reports for privately rated filing exempt assets. When the P&P Manual amendment was adopted to require the filing of rating rationale reports, the purpose was to provide transparency to regulators, with an expectation that the ratings would stand as is and unadjusted. Fiscal year-end 2023 will be the first fiscal year, since requiring the filing of rating rationale reports, in which the SVO will have the technology in place to receive these rating rationale reports from all insurers. We respectfully request that VOSTF first review the rating rationale reports received in 2023, and provide transparency back to industry following such review, prior to implementing additional requirements upon industry.

Furthermore, expected NAIC designations and the associated required capital is a key input in insurance company investment portfolio construction, capital management, and financial planning. Creating uncertainty on expected NAIC designations and, consequently, uncertainty in capital factors will add unnecessary complexity and result in excessive conservatism by industry to the detriment of policy holders. Nationally recognized statistical ratings organizations (NRSROs) are in a distinct position to provide feedback and updates to credit ratings in real time, allowing portfolio managers to make timely decisions. Each NRSRO is unique in its ability to cover certain asset types, sectors, and industries due to their proprietary rating methodologies and retention of staff with expertise and specialization in certain sectors – a critical component to identifying and understanding credit risk. In addition, NRSROs provide transparency into their ratings methodologies, processes, and output.

If this amendment is ultimately adopted, we respectfully request that the SVO offer the same level of transparency to industry as provided by the NRSROs and that the SVO publish the rating methodologies and criteria that it would apply so that insurers could reliably anticipate and form expectations regarding how an asset would be viewed by the SVO. Additionally, we request that the SVO provide a written rating rationale report with respect to any credit rating revoked pursuant to this proposal. Doing so in a timely manner would enable insurers and NRSROs to react and adjust appropriately, both with respect to the subject security and with respect to similar securities with NRSRO ratings.

An additional concern is that the timing of this proposal coincides with the upcoming implementation of the principles-based bond definition, also known as the "Bond Project". The Bond Project was started to address regulator concerns about certain assets that are reported on Schedule D and therefore filing exempt, and its impact constitutes a significant accounting change that has cascading effects, including causing insurers to undertake in-depth review and analysis of existing assets and the potential to materially affect capital and risk-based capital ratios. We expect that implementation of the Bond Project will address the same concerns this proposal is meant to address, and we urge the NAIC to allow implementation of the Bond Project to run its course before imposing upon insurers additional, overlapping regulatory requirements as set forth in this proposal.

We also ask that the VOSTF implement an independent appeal process to review disputes between the SVO and industry. In addition to the potential for disputes to arise because of this proposal, we believe that implementation of the Bond Project could lead to additional disputes between insurers and SVO staff due to the principals-based nature of the accounting standard and the degree of judgement to be exercised thereunder. If the SVO or a regulator were to disagree with the conclusion reached by a NRSRO, and the insurer believed the SVO's or regulator's conclusion was reached in error (whether due to lack of specific knowledge, a difference of professional opinion, or some other factor) an avenue for the insurer to appeal to an impartial and independent group with appropriate experience would be beneficial to all stakeholders.

In summary, we ask that this proposal be postponed and only reconsidered after the following has occurred:

- The publication of an issue paper detailing the specific concerns of regulators and the SVO following the review of the 2023 filed rating rationale reports and the subsequent collaboration between industry and the NAIC to arrive at a solution.
- The scope of potentially impacted securities is more narrowly defined.
- The impact of the Bond Project on the scope of this issue is understood.
- An independent appeal process is adopted; providing proper checks and balances to dispute resolution procedures.
- The SVO publishes its rating methodologies and develops standards similar to those applicable to NRSROs.

Sincerely,

Bob Turner

Bob Turner
Director, Investments

Michelle S. Delany
1349 SW Dyer Point Road
Palm City, FL 34990
michellesdelany@gmail.com

Ms. Carrie Mears, CFA
NAIC
Valuation of Securities Task Force

RE: Public Meeting Comments – May 15, 2023 - Comments on proposed due diligence

Dear Ms. Mears:

Nationally Recognized Statistical Ratings Organizations ("NRSRO") are for-profit entities, whose business is assessing the creditworthiness of issuers of debt, including but not limited to the issuers ability to repay the debt, likelihood of default and expectation of loss. Ratings agencies use various methodologies which they have developed and perfected over many years in the industry.

NRSRO's are regulated by the Securities and Exchange Commission ("SEC") and go through a rigorous application process and annual review of their methodology. The SEC adopted rules relating to the oversight of NRSRO's, in response to the requirements of the Credit Rating Agency Reform Act of 2006 and were enacted to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating agency industry.

NRSRO's must apply for registration with the SEC, make public certain information to help assess their credibility and implement procedures to manage the handling of material non-public information and conflicts of interest.

Credit ratings have been used extensively in financial regulation, including insurance regulation. Particularly for debt instruments, as with any extension of credit, the four Cs of credit are a critical aspect of the analysis. Character, Cash Flow, Collateral and Credit…these help the analyst to determine not only the creditworthiness of the borrower, but also the primary, secondary and tertiary source of repayment of the debt. NRSRO's are keen on analyzing the cash flow, but more importantly, they put eyes on the collateral, which in many cases is the most important. As an example for an investment property with anchor tenants, prudent analysis would warrant not only reviewing the lease terms, but also researching the tenant history to be sure that there are no issues with their payment history with their vendors. One can point to strip malls around the country which sit partially leased, because the anchor tenant moved out or worse yet went bankrupt, thus interrupting the cash flows and ultimately the borrowers ability to pay the debt service.

As a former portfolio manager / treasurer of a large regional bank, in addition to my own analysis, I have relied on the analysis of NRSRO's and the credit ratings issued to assist with investment decisions for the bank portfolio. The banks primary regulator, the OCC, in conjunction with the FDIC through the Federal Financial Institutions Examination Council, determines the leverage ratio for specific asset classes. That leverage ratio provides a risk weighting for the banks Capital Ratios, including total risk-based capital (Tier 1 and 2). **The regulators, however, do not issue ratings or designations.**

The SEC, EMSA and FCA conduct robust reviews of ratings firms and intentionally do not engage in issuing ratings themselves. All are considered independent and balanced in their approach.

It is highly unusual for a de-facto regulator (i.e., the SVO) to also be a market participant (i.e., by issuing designations), which for all practical purposes are ratings. The SEC does not conduct broker dealer operations, manage money, nor operate a stock exchange. Sound markets are critical to the health of our financial markets and our country.

If the SVO designations serve the same role as ratings, then they should be subjected to the same due diligence scrutiny by an independent review such as the SEC. For example, a publication of methodologies for publishing ratings/designations, annual reviews of methodologies and models, separation of the business and analytical side.

Due diligence on key suppliers is in best interest of all parties. However, to be most effective, the review should be completed by an independent third party and apply equally to all providers while relying in part on work done by other reviewers/regulators such as the SEC. The SVO has an inherent conflict because of its roles as both a de-facto regulator and a provider of ratings services and is not the appropriate party to conduct the review. Furthermore, there is no plausible reason why the SVO, which provided nearly 13,000 designations/ ratings should be excluded from a review.

The SVO claims that because it is overseen by state regulators, its ratings are superior. However, as stated above, NRSRO's are heavily regulated by a group within the SEC, which specializes in overseeing ratings firms. All rating firms are ultimately paid via the proceeds of transactions, and if the ratings were false or inaccurate, investors and issuers would restrict usage by those firms and the markets would follow suit by not buying the securities, thus creating a grave market disruption.

Following standard procurement policies and procedures, the NAIC, should issue and RFQ / RFP for third party entities to perform an arms-length review of the NRSRO's, including the SVO...The cost of contracting with the third-party consultant to perform this due diligence could be borne by the rating agencies.

Thank you for reviewing my comments.

Very truly yours,

Michelle S. Delany