Date: 4/27/2023

Valuation of Securities (E) Task Force
Monday, May 15, 2023
3:00 p.m. - 4:00 p.m. ET / 2:00 p.m. - 3:00 p.m. CT / 1:00 p.m. - 2:00 p.m. MT / 12:00 p.m. - 1:00 p.m. PT

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
Marlene Caride	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	Tim Hays	Washington
Nathan Houdek	Amy Malm	Wisconsin

NAIC Support Staff: Charles Therriault/Marc Perlman

AGENDA

Discuss and Consider for Exposure:

1. Proposed P&P Manual Amendment to Update the Definition of an NAIC Designation
(Doc. ID: 2022-012.05, 2022-012.01, 2022-012.02, 2022-012.03, 2022-012.04, 2021-047.01, 2021-047.02, 2021-047.03)
-Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC) — Attachment A, A-1, A-2, A-3, A-4, A-5, A-6, A-7

2. Proposed P&P Manual Amendment Authorizing the Procedures for the SVO's Discretion Over NAIC Designations Assigned Through the Filing Exemption Process
(Doc. ID: 2023.005-01)
-Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman — Attachment B

(NAIC)

3. Proposed P&P Manual Amendment to Clarify the meaning of Repurchase Agreement in the Derivatives Transaction Definition for Funds in Part Three
(Doc. ID: 2023.006-01)
-Carrie Mears (IA), Charles A. Therriault (NAIC), and Marc Perlman (NAIC) — Attachment C

Hear Staff Reports:

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

5. Any other matters

SVO

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

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.

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

DATE: September 30, 2022

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

- Standard 5 requires that insurer-owned securities be assessed in accordance with the standards promulgated by the NAIC IAO.
- Standard 2 refers to the NAIC Risk-Based Capital (RBC) for Insurers Model Act (#312) which assigns RBC factors for securities based on their credit risk as quantified by NAIC Designations.
- Standard 3 refers to the NAIC Accounting Practices and Procedures Manual, which uses NAIC Designations produced by the SVO and/or Price Grids produced by the SSG for statutory accounting purposes including to identify the valuation rules that apply to an investment.
- Standard 8 refers to state investment regulations which often incorporate NAIC model law provisions that relate asset allocations to credit quality or credit risk quantified by NAIC Designations.

- Standard 10 refers to the NAIC Credit for Reinsurance Model Law (#785), which refers to insurer-owned securities compiled by the SVO and identified on the List of Investment Securities, and in a separate provision, letters of credits issued by the banks and non-bank financial institutions whose name is placed on the NAIC List of Qualified U.S. Financial Institutions administered by the SVO, as eligible for use as collateral in reinsurance transactions.

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

- The likelihood of timely payment of principal and/or interest, as appropriate.
- The probability of default.
- The appropriateness and consistency of the risk-based capital model factor that will be applied to the security given its level of risk.
- Statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law.

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

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

ABOUT THIS MANUAL

…

Expression of NAIC Standards in State Law and Regulatory Processes

6. NAIC Designations and other SVO and SSG products are standards identified in the NAIC Policy Statement and Financial Regulation Standards (SFRS) that have been incorporated into state law by the States as participants in the Accreditation Program administered by the Financial Regulation Standards and Accreditation (F) Committee. Information about the F Committee and the Accreditation Program can be accessed here: www.naic.org/cmte_f.htm.

7. Part A of the SFRS identifies laws and regulations deemed necessary to financial solvency regulation. Analytical products of the SVO and SSG [sometimes collectively called the Investment Analysis Office (IAO)] are directly or indirectly incorporated into SFRS Part A standards.

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

8. NAIC Designations and other analytical products of the SVO and SSG are produced solely for the benefit of NAIC members in their capacity as state insurance department officials for use in the NAIC Financial Regulation Standards and Accreditation Program as described above. To ensure NAIC members have a central source from which to obtain information about insurer-owned securities (including their NAIC Designations) the VOS/TF has identified the AVS+ Products as the depository for information compiled by the SVO in the SVO List of Investment Securities.

…

NAIC Designations

37. The SVO's analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation that is notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations as defined in this Manual describe a credit quality-risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk except when accompanied by the NAIC Designation subscript, described below.

- Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.
- Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.
- The ability of an insurance company to realize payment on a financial obligation can be affected by factors not related to credit risk or by the manner in which the repayment promise has been structured.
- An NAIC Designation reflects the likelihood of timely payment of principal and interest, as appropriate, and the probability of principal and interest payment default.
- An NAIC Designation reflects the appropriateness and consistency of the risk-based capital model factor that will be applied to the security given its level of risk.

- An NAIC Designation must be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS).
- NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk.
- An NAIC Designation must be interpreted by the NAIC member in context of the NAIC Financial Regulation Standards and Accreditation Program, other characteristics of the investment, and the specific financial and regulatory status of the insurance company.

…

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS
APPLICABLE TO THE SVO

PRODUCTION OF 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 that reflects the likelihood of timely payment of principal and interest, as appropriate, the probability of principal and interest payment default, and the appropriateness and consistency of its use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) including the risk-based capital model factor that will be applied to the security given its level of risk. NAIC Designations are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law. NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer's capital structure, the likelihood of timely payment and risk of payment default. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual.

…

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-05-15 Interim meeting/01-Definition of NAIC Designation Part Two/2022-012.01 P&P Definition of NAIC Desig.docx

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December 5, 2022

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: "Clarify the Definition of NAIC Designations in…the *Purposes and Procedures Manual*…."

Dear Ms. Mears and Task Force Members,

This letter supports the concept of clarifying the definition of NAIC Designations. To achieve this the *Purposes and Procedures Manual* needs to be streamlined deleting duplicative language. Markups of the *Manual* with specific recommendations to accomplish this are attached. This letter also recommends approaches for dealing with what have been called "other non-payment risks" and I submit it as an independent consultant and long-time observer of the work of the Valuation of Securities Task Force.

NAIC Designations are Simply Opinions of Credit Risk

The *Manual* defines credit risk in Part One ¶37 as "the relative financial capability of an obligor to make the payments contractually promised to a lender." I believe this definition is reasonable and comprehensive in that it refers to "payments contractually promised" and nothing else, and this is reflected consistently in many places throughout the *Manual*. The Appendix to this letter shows over two dozen places where Designations are associated with credit risk.

Eliminating Unnecessary Language

The present text effectively defines NAIC Designations in separate three places. Because detailed descriptions for each of the six NAIC Designations appear in Part Two ¶21 – 24 other definitions (in Part One ¶37 and 88-89), are redundant and should be deleted. If additional information is needed to "clarify" the meaning of Designations it could be added to the section where the Designations are explained in detail where readers will naturally seek information about the meaning of Designations.

The *Manual* would also be made more usable by deleting unnecessary language such as Part One ¶6 - 8 which discusses the uses of Designations rather than what they actually are and how the SVO is charged with producing them.

Also in Part One are five bullet points in ¶37 discussing Designations. Rather than adding three more bullets as is proposed I recommend deleting this entire paragraph as each Designation is already discussed in detail in Part Two ¶21 – 24 as noted previously.

“Other Non-Payment Risk”

The references to “other non-payment risk” could be clarified. Given that Designations estimate the probability that a borrower will fulfil its commitments, if there are other reasons for “non-payment” they also need to be addressed explicitly.

Defaults are only one reason a lender may be uncertain about the amount of the payments it will receive. While defaults themselves are incorporated into RBC calculations, lending agreements increasingly contain other optional provisions that could change cash flows. These could be to the advantage, or detriment, of lenders. The question at hand is how to understand and deal with these uncertainties as to amounts due. This is distinctly different from the uncertainty about whether that amount will or will not be paid *i.e.* credit risk.

Possible Approaches

Callable bonds provide a simple an example of where cash flows can be uncertain. For instance, assume a ten-year 5% bond with a five-year call option which means it is subject to early redemption. The five-year call makes it possible that investors may not receive the last five years of interest payments. This uncertainty was well understood by the professionals who developed the RBC formula. It is not problematic, however, because of the standard market convention, then and now, for accounting for callable bonds.

The market convention for callable bonds assumes the lender will receive the worst of all possible outcomes without the default of the borrower. This is known as “yield-to-worst” which “is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting[*].” This is why it is possible to ignore the potential adverse impact of the exercise of a call option -- because the worst is already assumed.

Call features are not the only optional provisions that have been incorporated into the contractual promises of bond issues. It is possible to find other provisions embedded into agreements that can increase -- or decrease – expected payments even though the issuer remains in full compliance with the terms of the borrowing.

Solutions could be found for bonds where there is a lack of certainty concerning the actual dollar amount of cash flows that will be due by using concepts similar to “yield-to-worst”. The accounting and reporting would be relatively simple, “conservative” and most likely effective. It may bring with it some less desirable effects, however, so active discussion and collaboration is necessary. This concept could be implemented by coordinating with the Capital Adequacy Task Force and then SAPWG to develop appropriate reporting procedures.

Another approach would be to treat bonds with embedded options as hybrid securities -- having the characteristics both of debt and non-debt. Unfortunately risk-based capital formulas do not appear to

[*]Https://www.investopedia.com/terms/y/yieldtoworst.asp#:~:text=Yield%20to%20worst%20is%20a,it%20out%20 before%20it%20matures.

contemplate such structures presently so in all probability it would require extensive coordination to make this change.

While any possible approach certainly should be discussed at this Task Force along with Capital Adequacy and Statutory Accounting, attempting to layer these risks of option exercise into the existing credit risk structure appears to have relatively little potential. Not only would it be difficult to quantify the added uncertainty by folding these two different risks into Designations but it would also conflate the two and seriously compromise the integrity of Designations. This would make it difficult for them to be used in RBC calculations. Such action should be taken in coordination with the Capital Adequacy Task Force.

Denying that these assets are "bonds" would also be problematic. In fact they are bonds: borrowings with the promise to repay, so they should be classified as such even as work is done to assure reasonable reporting of actual amounts due

Summary

The definition of Designations can be clarified by omitting unnecessary words as shown in the attachment.

Incorporating a "yield to worst" methodology would allow regulators to address the uncertainty in the amount of reported cash flows beyond what is already reflected in measures of credit quality.

Christopher Anderson.

Copies: Charles Therriault and Denise Genao-Rosado

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

ABOUT THIS MANUAL

…

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

6. ~~NAIC Designations and other SVO and SSG products are standards identified in the NAIC Policy Statement and Financial Regulation Standards (SFRS) that have been incorporated into state law by the States as participants in the Accreditation Program administered by the Financial Regulation Standards and Accreditation (F) Committee. Information about the F Committee and the Accreditation Program can be accessed here: www.naic.org/cmte_f.htm.~~

7. ~~Part A of the SFRS identifies laws and regulations deemed necessary to financial solvency regulation. Analytical products of the SVO and SSG [sometimes collectively called the Investment Analysis Office (IAO)] are directly or indirectly incorporated into SFRS Part A standards.~~

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

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~~8 NAIC Designations and other analytical products of the SVO and SSG are produced solely for the benefit of NAIC members in their capacity as state insurance department officials for use in the NAIC Financial Regulation Standards and Accreditation Program as described above. To ensure NAIC members have a central source from which to obtain information about insurer-owned securities (including their NAIC Designations) the VOS/TF has identified the AVS+ Products as the depository for information compiled by the SVO in the SVO List of Investment Securities~~

~~**NAIC Designations**~~

~~37. The SVO's analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation that is notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations as defined in this Manual describe a credit quality-risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk except when accompanied by the NAIC Designation subscript, described below.~~

- ~~Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.~~

- ~~Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.~~

- ~~The ability of an insurance company to realize payment on a financial obligation can be affected by factors not related to credit risk or by the manner in which the repayment promise has been structured.~~

- ~~An NAIC Designation reflects the likelihood of timely payment of principal and interest, as appropriate, and the probability of principal and interest payment default.~~

- ~~An NAIC Designation reflects the appropriateness and consistency of the risk-based capital model factor that will be applied to the security given its level of risk.~~

- ~~An NAIC Designation must be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS).~~

- ~~NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk.~~

- ~~An NAIC Designation must be interpreted by the NAIC member in context of the NAIC Financial Regulation Standards and Accreditation Program, other characteristics of the investment, and the specific financial and regulatory status of the insurance company.~~

Definitions

88. ~~**NAIC Designation** - Means any one of the gradations of credit quality and credit risk identified by the **NAIC 1** through **NAIC** 6symbols **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.~~

~~89. **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.~~

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

PRODUCTION OF 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 **are measures of the credit risk which is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender.** ~~of individual debt instruments concerning the identify a category or band of credit risk that reflects the likelihood of timely payment of principal and interest, as appropriate, the probability of principal and interest payment default, and the appropriateness and consistency of its use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) including the risk-based capital model factor that will be applied to the security given its level of risk.~~ ~~NAIC Designations are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law. NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer's capital structure, the likelihood of timely payment and risk of payment default. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual.~~

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.

APPENDIX

Throughout the P&P Manual there are numerous and consistent descriptions showing that the SVO is charged with assessing credit risk which is defined in Part One, ¶ 37 as "the relative financial capability of an obligor to make the payments contractually promised to a lender."

Here are over two dozen examples of that:

P1 29 "The NAIC, therefore, rejects the view that insurance company representatives may reasonably rely on SVO credit assessments"

P1 32 "This process is distinct from the SVO's assessment of an investment's credit risk, which results in a NAIC Designation"

P 1 34 "Because SVO analytical determinations of credit quality do not convey opinions, conclusions or informational content relative to statutory accounting status, the SVO may assign an NAIC Designation…."

P1 36 " The SVO shall conduct the following ongoing operations:
Analysis of credit risk for purposes of assigning an NAIC Designation…."

P1 38 "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.

P1 38 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

P1 Note Prior to 57 "NOTE: See "Policies Applicable to the Filing Exemption (FE) Process" below; "NAIC Policy on the Use of Credit Ratings of NRSROs"

P1 82 "and "Use of Credit Ratings of NRSROs In NAIC Processes" and "Definition - Credit Ratings Eligible for Translation to NAIC Designations"

P1 85 "85. NAIC Designation is Capped to Highest NAIC CRP Rating -The SVO shall not assign an NAIC Designation for a security that has a credit rating assigned by an NAIC CRP when the NAIC Designation would express an opinion of credit quality higher than that indicated by the rating assigned by the NAIC CRP, except…"

Definitions

88. 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.

89. 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.

Part Two

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

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

31. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation.

36. The SVO shall conduct the following ongoing operations:

- Analysis of credit risk for purposes of assigning an NAIC Designation.
- Identification and analysis of securities that contain other non-payment risk and communication of this information by assignment of the NAIC Designation subscript to such securities.

42. Illustration - The distinctions in credit risk made in the notching process involve (conceptually) the issuer's actual capital structure. The hypothetical capital structure below is shown to illustrate and explain notching:

Senior secured	Notch up from the benchmark
Senior unsecured	Benchmark NAIC Designation
Senior subordinated	Notch down from the benchmark
Junior subordinated	Notch down from benchmark
Preferred stock	Notch down from benchmark

97. For purposes of this section, probable regulatory treatment means the professional opinion of the SVO as to the credit quality designation

143. Listing a Counterparty-An insurance company that wants to have a counterparty listed on the List of Counterparties Rated by the SVO for Schedule DB, Part D, Section 1 shall submit to the SVO:…

…Evidence of an NAIC CRP counterparty rating, an NAIC CRP senior unsecured rating or a copy of the most recent Audited Financial Statement for the counterparty, or the counterparty's guarantor, so that the SVO can assess credit quality and assign an NAIC Designation

155. An NRSRO that wishes to provide Credit Rating Services to the NAIC may indicate its interest by sending a letter to the Chair of the VOS/TF with a copy to the Director of the SVO, in which it:…

- …Provides a chart relating its credit rating symbols to NAIC Designations.

Part Three

46. The following terms have the meaning shown below:

■ Credit Substitution Methodology - Refers to an analytical technique in which an NAIC Designation is assigned to a security on the basis of the credit strength of a third party

279. Credit Risk Assessment - A calculation of the credit risk of a fund's underlying investment portfolio using a weighted average rating factor methodology (WARF)….
NAIC Fund Methodology*

287. The SVO shall:

- Conduct a look-through assessment
- Conduct a credit-risk assessment to determine the credit risk of the fund's cash flows.
- Conduct a speculative characteristics analysis.
- Determine whether the fund's cash flow can or cannot be appropriately
- characterized as fixed income like for regulatory purposes.
- If the SVO determines that the fund's cash flow can be appropriately characterized as fixed income for regulatory purposes, it assigns an NAIC Designation to reflect the credit risk associated with the fund's cash flow and includes the name of the fund on the appropriate NAIC List.**

** NOTE: The NAIC Designation does not address the fund's ability to meet payment obligations because the insurer/ shareholder does not own the bonds in the portfolio; the NAIC Designation instead conveys the credit risk/ quality of the fixed income like cash flow generated by the ETF.

Mike Monahan
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December 5, 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 Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "P&P Manual") to Clarify the Definition of an NAIC Designation in Part One and Part Two

Dear Ms. Mears,

The undersigned (ACLI, PPIA, 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 October 20, 2022.

The undersigned generally like to provide constructive comments surrounding VOSTF exposures (and NAIC exposures more generally). We consistently ask ourselves the following questions:

1) What objective(s) are the proposed changes trying to achieve?
2) Do the proposed changes achieve the objective(s) and/or are they appropriate?
3) If the proposed changes do not achieve the objective, or are not appropriate, what constructive comments can we provide?

Our comments will be provided through this lens for both Part One Proposed Changes and Part Two Proposed Changes.

Part One Proposed Changes

The proposed changes to Part One of the P&P Manual can appear benign, but the objective is unclear. The following provides some thoughts for which VOSTF members may want to consider prior to adopting.

As previously noted by industry, regulators and the SVO, the P&P Manual can be at times difficult to follow and interpret. Industry believes that are three reasons, in part, that contribute to this difficulty:

1) The objectives of proposed changes included within exposures are at times themselves not sufficiently clear and/or the practical considerations only becomes known at some later date through subsequent interpretation.
2) Over time, changes to the P&P Manual are made that are incremental without fully considering what is said in other parts.
3) There are ambiguities and inconsistencies between parts, or even within parts, which make understanding the P&P Manual challenging and open to interpretation.

The proposed changes to Part One have an overriding objective to "Clarify the Definition of an NAIC Designation" and includes the following proposed changes to paragraph 37, in Part One of the P&P Manual, which defines what an NAIC designation represents:

1) An NAIC Designation reflects the likelihood of timely payment of principal and interest, as appropriate, and the probability of principal and interest payment default.

2) An NAIC Designation reflects the appropriateness and consistency of the risk-based capital model factor that will be applied to the security given its level of risk.

3) An NAIC Designation must be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS).

Theoretically, the proposed changes could be hard to argue against (e.g., NAIC designations should be consistent with the risk-based model factors). However, the proposed changes may be more aspirational and not achieve the objective of trying to "Clarify the Definition of an NAIC Designation."

For example, it is our understanding the risk-based capital factors were developed using Moody's historic corporate bond default and loss given default data. If the first two proposed changes are added to what an NAIC Designation represents, will this provide additional clarity or just raise additional questions?

More specifically, if NAIC designations represent "probability of default" while the risk-based capital factors "represent both probability of default and the loss given a default" – are NAIC Designations and risk-based capital factors, by definition, inconsistent? Does this provide additional clarity or just raise further potential inconsistencies?

What practical considerations do the proposed changes have?

1) Do the NAIC risk-based capital factors need to be changed to be consistent with the definition of an NAIC Designation?

   Our understanding, from recent discussions with the majority of rating agencies, is that they all essentially utilize a blended probability of default/loss given default methodology for rating bonds – e.g., more of a probability of default for investment grade securities, with a shift in direction toward factoring in loss given default for securities at the lower end of investment grade or below investment grade, although the specifics depend upon rating agency, type of security, and situational context.

2) Does this mean that some, part, or all of rating agencies' ratings, upon which NAIC Designations are based, are not consistent with the risk-based capital factors – i.e., NAIC designations need to change to be consistent with the NAIC risk-based capital factors?

   It is our understanding that not only are the risk-based capital factors based on both probability of default and the loss given a default, but they are also based on the universe of public bonds rated by Moody's.

3) Does this mean that only NAIC Designations based upon Moody's ratings, or SVO evaluations utilizing a methodology consistent with Moody's methodology, consistent with the NAIC risk-based capital factors?

Prior to adopting this language, we urge the VOSTF to carefully think through these questions, including any practical considerations related to an NAIC Designation being in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS). If the proposed changes are deemed appropriate, and the VOSTF members want to adopt them, industry has only two asks.

One, the first proposed change would need to include the shaded language to 1) be consistent with paragraph 35 (included in Part Two of the P&P Manual and discussed below) and 2) not be inconsistent with the second last bullet of paragraph 37 related to liquidity and deferrals.

> *An NAIC Designation reflects the likelihood of timely payment of principal and interest (as defined in the contractual debt documents), as appropriate, and the probability of principal and interest payment default.*

Two, share with industry any further objective(s), including any practical considerations or implications of the proposed changes, so industry is not surprised of their impact via a subsequent interpretation.

Part Two Proposed Changes

The other proposed change relates to Part Two of the P&P Manual entitled, "Operational and Administrative Instructions Applicable to the SVO," the first paragraph (paragraph 18) of the "Production of NAIC Designations" section. The whole of that section is included as an Attachment to this letter as we will be referring to specific paragraphs. The proposed changes to paragraph 18 are included below:

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 that reflects the likelihood of timely payment of principal and interest, as appropriate, the probability of principal and interest payment default, and the appropriateness and consistency of its use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) including the risk-based capital model factor that will be applied to the security given its level of risk. NAIC Designations are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law. NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer's capital structure, the likelihood of timely payment and risk of payment default. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual.*

Unlike the proposed changes to Part One, which are related to the definition of an NAIC Designation, this section relates to "Operational and Administrative Instructions Applicable to the SVO."

No rationale was provided as to the objective for these changes. However, the section suggests the proposed changes relate to operational and/or administrative changes applicable to the SVO.

Currently, industry understands there are two instances for which notching is appropriate in the P&P Manual – 1) "position of a specific security in the issuer's capital structure" and 2) "non-payment risk" related to Subscript S securities. Both instances are mentioned in paragraph 18 above, and each more fully explained in the section attached to this letter.

Industry understands these notching procedures are applied to securities that are not filing exempt. The SVO, not unlike how rating agencies apply their rating methodologies, designates the issuer and adjusts the designation for where the specific security is within the capital structure. In paragraph 39, notching for Subscript S is utilized "routinely, for any security or financial product filed with the SVO."

Currently, it appears the SVO makes limited use of Subscript S notching as evidenced by relatively few Subscript S designations as described in paragraph 38 of the attachment. However, the SVO is concurrently looking to expand the definition of Subscript S securities in ways that conflict with the definition of an NAIC designation, as highlighted in our letter of September 12, 2022, while also suggesting it applies to filing exempt securities. However, the proposed changes now add a third instance for notching: 3) "likelihood of timely payment and risk of payment default." There is no further objective of explanation for this third instance.

Close examination of the P&P Manual language related to Subscript S securities (i.e., paragraph 39) suggests it does not apply to filing exempt securities. If this interpretation is incorrect, the addition of the proposed language, which is a third instance of notching in the highlighted portion of the paragraph above, would then seem to suggest notching itself applies to all securities that are filing exempt and raises the question of whether all securities need to be filed with the SVO (i.e., essentially all securities have to be adjusted for where they are within the capital structure by the SVO (as are already done so by rating agencies) and for which the SVO wants to notch due to not meeting the "likelihood of timely payment and risk of default" (see also our comments related to similar but not identical language under Part One above that also needs adjustment in that context)).

The SVO has not been able to explain to industry which populations of securities are subject to notching – filing exempt securities, filed securities, neither, or both. Combined with other recent and concurring exposures, such as the proposed expansion of securities meeting the definition of Subscript S, and the lack of insight into the overall rationale and objectives of this part of the VOSTF exposure, industry is challenged to fully react to and provide constructive comments due to our lack of understanding of what the practical implications and considerations are. Therefore, with regards to the proposed changes to Part Two, we ask the VOSTF to help industry understand such objectives and practical implications.

In summary, we are uncertain as to the actual objectives and the likely downstream effects, and do not want to be surprised by their impact upon any future subsequent interpretation.

*****

We stand ready to work collaboratively with the Task Force and SVO on this and other matters in the future.

Sincerely,

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey
Tracey Lindsey
NASVA

John Petchler
John Petchler
on behalf of PPiA
Board of Director

PRODUCTION OF 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.

SVO NOTCHING GUIDELINES

Definition and Purpose

40. Notching is defined as the process used to make distinctions between different liabilities in an issuer capital structure to reflect differences in credit or other non-payment risk smaller than a whole grade. Notching expresses differences in expected loss (i.e., severity) of an issuer's liabilities by their relative priority of claim in bankruptcy.

41. With the exception of **NAIC 6**, notching distinctions are expressed by combining an NAIC Designation with an NAIC Designation Modifier to produce an NAIC Designation Category. For example, as shown in the table above, **NAIC 1** is combined with NAIC Designation Modifier 1.A to produce the NAIC Designation Category 1.A. Modifiers are used with or assigned to the **NAIC 6** Designation.

Notching NAIC Designation Categories (to Reflect Credit Risk)

42. **Illustration** – The distinctions in credit risk made in the notching process involve (conceptually) the issuer's actual capital structure. The hypothetical capital structure below is shown to illustrate and explain notching:

Senior secured	Notch up from the benchmark
Senior unsecured	Benchmark NAIC Designation
Senior subordinated	Notch down from the benchmark
Junior subordinated	Notch down from benchmark
Preferred stock	Notch down from benchmark

Methodology

43. The SVO determines the benchmark NAIC Designation Category for the senior unsecured obligation of the issuer or its equivalent. The SVO adjusts the benchmark NAIC Designation Category up or down to reflect the difference in risk between the benchmark security and the specific liability under review by the SVO.

SVO Guidelines for Notching

44. The SVO shall notch an NAIC Designation Category for an issuer up or down to reflect the position of a specific liability in the issuer's capital structure.

45. Notching upward from a benchmark NAIC Designation Category is almost exclusively associated with transactions in which the SVO determines that collateral act to further reduce the probability of default from that implied by the issuer's senior unsecured NAIC Designation Category.

46. In determining the number of notches that should be applied to a security, the SVO shall apply the following guidelines.

Notching Investment Grade Issuers

47. Notching for issuer's whose senior unsecured benchmark NAIC Designation is **NAIC 1** and **NAIC 2** is therefore based on the following general guidelines:

    - **Secured debt** may be designated one notch above the senior unsecured issuer designation.
    - **Subordinated debt** (including junior and senior subordinated) are generally designated one notch below the senior unsecured rating.
    - **Preferred debt** will generally be designated one notch below subordinated debt (two below senior unsecured or senior implied).
    - **Holding company debt** is generally designated at or below the lowest rated debt security that would be assigned at the principal operating company.

Notching for Non-Investment Grade Issuers

48. Given the risks associated with non-investment grade issues, notching for issuer's whose senior unsecured benchmark NAIC Designation is **NAIC 3**, **NAIC 4** and **NAIC 5** requires grater professional judgment and discretion.

49. As such, notching differentials for issuers with **NAIC 3**, **NAIC 4** and **NAIC 5** Designations may be wider than for issuer's whose senior unsecured NAIC Designation is **NAIC 1** or **NAIC 2**.

Notching for NAIC Designation Subscript (to Reflect Non-Payment Risk Unrelated to Credit Risk)

50. **Grant of Significant Discretion** – The SVO is granted significant discretion to determine the number of notches it will assign to a security to reflect other non-payment risk. This discretion is to be exercised in the context of the regulatory objective and purpose of this procedure. SVO determinations made under this subparagraph are subject to review in accordance with the procedures described of this Part, above.

Relevant Considerations

51. The name given to the security is not relevant to a determination whether this subparagraph should be applied. The relevant criterion is whether the risks in the security are clearly credit risks or whether they are not clearly credit risks.

52. Factors the SVO may deem relevant to the question of notching for other non-payment risk may include:

    - Any security or financial instrument denominated with a term associated with fixed income investments must contain a clearly stated obligation to pay a return and to repay the amount of the principal repayment. Otherwise it is not rational or possible to assign an NAIC Designation.

    - Any security or financial instrument denominated as fixed income that does not contain a legally binding obligation to pay shall not be assigned an NAIC Designation and instead will be reported to the VOS/TF and the Chief Examiner of the State of Domicile.

    - Any security or financial instrument that is denominated as fixed income and that contains a promise to pay that is otherwise conditional may be notched either under this subparagraph to reflect other non-payment risks or under the notching procedure for credit risk to reflect the expected loss of that obligation in the issuer's specific capital structure, depending on which approach seems more appropriate to the SVO.

53. The widest degree of notching for a security or financial instrument is likely to be for a security that is denominated as fixed income, but which is deemed to be a perpetual investment and to not require payment of dividends.

54. In contracts that permit the issuer flexibility to not make payments, the SVO would focus on the degree of financial discretion afforded the issuer to not make payments and the circumstances under which that financial flexibility will be exercised.

55. In contracts where the insurer agrees to accept a risk or participate in an activity that may reduce either the interest or dividend otherwise agreed on or the amount to be repaid to less than the original principal investment, the SVO would consider whether the risk of a loss is structurally or otherwise mitigated.

56. Notching differentials are expected to be wider for **NAIC 3**, **NAIC 4** and **NAIC 5** issuers because the issuer's credit risk is deemed to increase the likelihood that the issuer will avail itself of contractually provided flexibility to not pay or increase the likelihood of a loss as a result of the insurer's participatory activity.

57. Deferral of dividends in a security denominated preferred stock is presumed to be subject to notching for credit risk subject to an SVO determination that the denomination is not truly reflective of the terms of the agreement in which case it may be more appropriately notched for other than credit risk.
58. In a given capital structure, the priority of payment due to an investor may be so subordinated as to require treatment under these guidelines for other non-payment risk. This is especially true where deep subordination is combined with a right to defer interest.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

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

FROM: Tom Botsko, Chair, Capital Adequacy (E) Task Force and Property and Casualty Risk-Based Capital (E) Working Group
Philip Barlow, Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group and Life Risk-Based Capital (E) Working Group
Steve Drutz, Chair, Health Risk-Based Capital Working Group

DATE: December 8, 2022

RE: Clarification of the Definition of an NAIC Designation in Part One and Part Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) *(Dated Sept. 30, 2022) Amendment to Nov. 30, 2022, Comment Letter*

Thank you for the opportunity to provide additional feedback on the letter that was provided to this group dated Nov. 30, 2022.

Upon further discussion with the Valuation of Securities (E) Task Force in the last several days, we have a better understanding of the concept it was proposing with the original wording.

Therefore, we will be working together on revised wording for this bullet point that expresses how the Valuation of Securities (E) Task Force works with the Capital Adequacy (E) Task Force, the Life Risk-Based Capital (E) Working Group, the Health Risk-Based Capital (E) Working Group, the Property and Casualty Risk-Based Capital (E) Working Group, and the Risk-Based Capital Investment Risk and Evaluation (E) Working Group to use the designations provided by Valuation of Securities (E) Task Force in the analysis for determining the risk-based capital (RBC) charges.

Thank you for the opportunity to provide input to this exposure. We look forward to discussing this with you and the Task Force at your convenience.

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NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

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

FROM: Tom Botsko, Chair, Capital Adequacy (E) Task Force and Property and Casualty Risk-Based Capital (E) Working Group
Philip Barlow, Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group and Life Risk-Based Capital (E) Working Group
Steve Drutz, Chair, Health Risk-Based Capital Working Group

DATE: November 30, 2022

RE: Clarification of the Definition of an NAIC Designation in Part One and Part Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) *(Dated Sept. 30, 2022)*

Thank you for the opportunity to provide feedback on the update to the exposed definition on the referenced document. Under part 37 of the NAIC designation section, the second added bullet item states the following:

"An NAIC Designation reflects the appropriateness and consistency of the risk-based capital model factor that will be applied to the security given its level of risk."

We believe that this statement conflicts with the mission and purpose of the Capital Adequacy (E) Task Force, the Life Risk-Based Capital (E) Working Group, the Health Risk-Based Capital (E) Working Group, the Property and Casualty Risk-Based Capital (E) Working Group, and the Risk-Based Capital Investment Risk and Evaluation (E) Working Group. Therefore, we recommend that this bullet point be removed. While the appropriate designation assignment is important, it is the responsibility of the Capital Adequacy (E) Task Force and the supporting risk-based capital (RBC) working groups to determine and recommend the appropriate charge (model factor) in all aspects of the RBC formulas.

In addition, the next to last bullet point of this same section mentions that the NAIC designations do not measure other risks. This further supports the request to remove this proposed item. The Capital Adequacy (E) Task Force and its working groups assess all the risks as appropriate to determine the RBC charge associated with the investment. An investment's designation may result in a different RBC factor once the specific investment type is analyzed. While an NAIC designation may be used for multiple types of investments, the appropriate RBC charge may vary greatly depending on the analysis, and in particular, because of the type of investment.

Once the Capital Adequacy (E) Task Force is aware of a change or implementation of a new or revised designations, the Task Force and it's working groups will work with the other working groups or task forces to determine the best approach to evaluate the appropriate RBC charge associated with the assigned designation for a given investment type.

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www.naic.org

As you may recall, the Risk-Based Capital Investment Risk and Evaluation (E) Working Group was created to work with the Valuation of Securities (E) Task Force and other groups in parallel to streamline the process of determining and evaluating the appropriate RBC charge for new investment types. As investments are recommended to be reported separately in the annual statement, the Risk-Based Capital Investment Risk and Evaluation (E) Working Group should receive a referral or at least be made aware of the plan to segregate a new investment type for reporting purposes. The Capital Adequacy (E) Task Force and the Risk-Based Capital Investment Risk and Evaluation (E) Working Group need to keep in close communication with these proposals to make sure an appropriate charge is available when the reporting change is implemented. In addition, if the reason for a plan to segregate a specific investment type for reporting purposes is primarily to change the applicable RBC charge, the Risk-Based Capital Investment Risk and Evaluation (E) Working Group should discuss whether this segregation is appropriate prior to any plan to segregate the investment type.

Because the Risk-Based Capital Investment Risk and Evaluation (E) Working Group is relatively new to the Capital Adequacy (E) Task Force, it is imperative that we all communicate our priorities and proposals to improve the process.

As the Risk-Based Capital Investment Risk and Evaluation (E) Working Group takes on its new responsibilities, it will continue to prioritize its tasks, as well as any new proposals.

Thank you for the opportunity to provide input to this exposure. We are happy to discuss this with you and the Task Force at your convenience.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-05-15 Interim meeting/01-Definition of NAIC Designation Part Two/2022-012.04 Memo to the VOSTF (002).docx

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Kevin Fry, 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: Update the Definition of Other Non-Payment Risk Assigned a Subscript "S" in the P&P Manual

DATE: November 15, 2021

Summary – Securities that possess "Other Non-Payment Risks" are intended to be reviewed by the SVO but these investments have not been explicitly included on the list of Specific Populations of Securities Not Eligible For Filing Exemption in Part Three of the *Purposes Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). Securities with other non-payment risks are identified through assignment of the Administrative Symbol "S" as a subscript to the NAIC Designation. This amendment adds "Securities with Other Non-Payment Risks" to the list of securities that are ineligible for filing exemption.

As noted in Part One, paragraph 90, of the P&P Manual, "*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.*"

The proposed amendment further clarifies through additional illustrations that securities that:

a) incorporate the performance of other assets to determine their contractual payments, either directly or indirectly through reference pools, equity baskets, or indices;

b) receive payments as the remainder or residual cashflow after all other payment obligations have been made;

c) receive additional performance or bonus cashflows; or

d) have no contractual events of payment default;

would also be considered as having "Other Non-Payment Risks".

Proposed Amendment - The text changes to update the definition of "Other Non-Payment Risks" and include Securities with Other Non-Payment Risk as a security type ineligible for filing exemption is shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2021 P&P Manual format.

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

NAIC DESIGNATION SUBSCRIPT S

Description of Other Non-Payment Risk

32. 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.

33. 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.

34. 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).

35. 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 date~~s~~ (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 scheduled payments of interest and repaying principal in full to the insurer on a date certain;
  - *Illustration* – A security that incorporates the performance of other assets to determine contractual payments, principal or interest, either directly or indirectly through references to asset pools, equity baskets, or non-interest rate indices.
  - *Illustration* – A security that receives payments as the remainder or residual cashflow after all other payment obligations have been made.
  - *Illustration* – A security that receives performance or bonus cashflows in addition to scheduled payments of principal and interest.
  - *Illustration* – A security with no contractual events of payment default.
- 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

36. 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**.

37. 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.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

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

…

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 with Other Non-Payment Risks** – As noted in Parts One and Two of this Manual, the regulatory assumption of 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 security that is inconsistent with this assumption 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.

ACLI Financial Security for Life | PPiA Private Placement investors Association | NASVA

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

February 10, 2022

Ms. Carrie Mears, Chair
Valuation of Securities Task Force
National Association of Insurance Commissioners
1100 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 American Council of Life Insurers ("ACLI"), Private Placement Investors Association ("PPIA"), and North American Securities Valuation Association ("NASVA") ("the undersigned") appreciate the opportunity to engage with state regulators and the NAIC on the SVO's proposed Amendment to the P&P Manual to update the definition of Other Non-Payment Risk assigned a Subscript S.

The Proposed Amendment proposes the following two distinct additions to the P&P Manual:

1) The proposed addition of Subscript S securities (collectively) to the list of securities explicitly noted to be non-eligible for filing exemption in the P&P Manual, and
2) The proposed addition of four illustrations to the definition of Subscript S securities with other non-payment risk.

The undersigned offer the following comments on these proposals. For the purposes of brevity, we will not repeat our comments made in our letter of the same date, on the Proposed Amendment to the P&P Manual to update the definition of Principal Protected Securities (PPS), as we believe the two proposed amendments are highly interrelated. The undersigned respectfully request readers to read that letter first to understand the full context of our comments below.

1) Subscript S securities are already not eligible for filing exemption, and the Subscript S proposed amendment, recommends collectively and explicitly adding Subscript S securities to the list of non-filing exempt securities. The undersigned support this proposal, in concept, because we believe they were inadvertently left off the list due to a historical oversight. As such, collectively adding Subscript S securities to the list of securities not eligible for filing exemption will improve the clarity and usability of the P&P Manual.

2) Prior to adding Subscript S securities to the list of non-eligible filing exempt securities, we recommend the following four steps:
    i. Add the PPS definition, as currently written in the P&P Manual, to the list of illustrations (i.e., examples) already included under Subscript S definition. See also our letter, referred to above, related to PPS as well as our comments included below for more context.
    ii. Remove PPS from the list of securities not eligible for filing exemption, consistent with other examples of Subscript S securities. See also our letter, referred to above, related to PPS for more context.
    iii. Define separately the new concern related to PPS as a separate illustration (example) within the Subscript S definition. We believe trying to layer on this concern, atop the PPS definition, will make the already current and complex PPS definition, potentially unworkable. Further, it appears at least some of proposed four new additions to the Subscript S definition are already an attempt by the SVO to do so. The concern should only be addressed in one spot to ensure as much clarity and usability in the P&P Manual as possible. See also our letter, referred to above, related to PPS.
    iv. The proposed amendment also includes four additional illustrations to the Subscript S definition without any context for their proposed inclusion. We understand at least some of these proposed new additions are related to concerns with PPS-like securities created by means other than that illustrated within the PPS definition. There is widespread confusion among the undersigned's constituency as to what specifically the SVO is trying to address with the four examples, but more importantly, what do they all potentially capture by way of unintended consequences. We therefore propose that we jointly work with the SVO, to more fully understand the explicit concerns, so we can jointly address those concerns and importantly ensure continued clarity and usability of the P&P Manual – consistent with the other examples included within Subscript S.

We discussed these concepts with Charles Therriault, and his team, and suggested we would like to work with the SVO to address this matter in the most efficient way possible. Our understanding is Charles and team are amenable to this suggestion.

We look forward to working with the SVO and regulators on this issue.

Sincerely,

Mike Monahan
Senior Director, Accounting Policy

Tracey Lindsey

Tracey Lindsey
NASVA

John Petchler

John Petchler
on behalf of PPiA
Board of Directors

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-04 - Spring National Meeting/03 - Update Definition Subscript S/2021-047.02 ACLIJointComments_VOSTF_Subscript S.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)

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

RE: Update the Definition of Other Non-Payment Risk Assigned a Subscript "S" in the P&P Manual

DATE: July 11, 2022

Update – At the 2022 Spring National meeting the SVO was directed to work with industry on technical modifications to this proposed amendment that was first exposed at the 2021 Fall National Meeting. The SVO met with representatives of the American Council of Life Insurers (ACLI), Private Placements Investors Association (PPiA) and North American Securities Valuation Association (NASVA) on Apr. 29, May 6 and 24, and Jun. 17. The attached revised amendment reflects items discussed during those meetings. There was not consensus on three primary issues, each a proposed illustration of Other Non-Payment Risk warranting a Subscript S: (1) maturities equal to or exceeding 40 years, (2) certain deferred principal payment features, and (3) certain deferred interest payment features. Maturities exceeding 40-years have the characteristic of perpetual or permanent capital and deferred interest or principal is inconsistent with the regulatory assumption 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.

The SVO recommends adopting the definitional updates to Part Two of the P&P Manual and temporarily deferring the proposed Part Three instructions to remove securities with Other Non-Payment Risk from filing exemption (FE). This temporary deferral is intended to give industry sufficient time to find and provide examples of securities that are publicly rated by different credit rating providers (CRP) which have the three characteristics listed above for which there was not consensus so that the SVO can study them.

Summary – Securities that possess "Other Non-Payment Risks" are intended to be reviewed by the SVO but these investments have not been explicitly included on the list of Specific Populations of Securities Not Eligible For Filing Exemption in Part Three of the *Purposes Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). Securities with other non-payment risks are identified through assignment of the Administrative Symbol "S" as a subscript to the NAIC Designation. This amendment adds "Securities with Other Non-Payment Risks" to the list of securities that are ineligible for filing exemption.

As noted in Part One, paragraph 90, of the P&P Manual, "*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.*"

The proposed amendment clarifies through additional illustrations the types of securities that would be considered as having "Other Non-Payment Risks".

Proposed Amendment - The text changes to update the definition of "Other Non-Payment Risks" and include Securities with Other Non-Payment Risk as a security type ineligible for filing exemption is shown below with additions red underline, deletions in ~~red strikethrough~~, existing text that has been moved in green and text to defer in yellow highlight, as it would appear in the 2022 P&P Manual format.

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

NAIC DESIGNATIONS

. . .

NAIC Designation Subscript S

90. An objective of the VOST/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.

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

…

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

PRODUCTION OF NAIC DESIGNATIONS

…

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 date~~s~~ (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 scheduled payments of interest and repaying principal in full to the insurer on a date certain;
  - ~~*Illustration* – A security that incorporates the performance of other assets to determine contractual payments, principal or interest, either directly or indirectly through references to asset pools, equity baskets, or non-interest rate indices.~~
  - ~~*Illustration* – A security that receives payments as the remainder or residual cashflow after all other payment obligations have been made.~~
  - ~~*Illustration* – A security that receives performance or bonus cashflows in addition to scheduled payments of principal and interest.~~
  - *Illustration* – A Principal Protected Security, as defined in Part Three of this Manual.
  - *Illustration* – A security with no contractual events of payment default.
  - *Illustration* - ~~Insurer agrees to an exposure that has~~ A security with contractual terms that have the potential to result ~~a significant delay~~ in payment of contractually promised interest and/or return of principal in an amount less than the original investment.
  - *Illustration* – 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.
  - *Illustration* – A security with interest payment deferral feature that does not capitalize interest into principal or permits interest deferral for greater than twelve 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.~~

Meaning of the Subscript S Symbol

37. 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**.

38. 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.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

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

…

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:

...

Deferred

- **Securities with Other Non-Payment Risks** – As noted in Parts One and Two of this Manual, the regulatory assumption of 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 security that is inconsistent with this assumption 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.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2021/12 December FALL NATIONAL METING/04 - Other Non-payment Risk subscript S/2021-047.01 Task Force 2021 Amend PP Other Non-Payment Risk.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: 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.

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.

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PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

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

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

FE SECURITIES

Filing Exemption

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

Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:

   …

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

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/Work-in-Progress/SVO Discretion/2023-xxx.01 P&P SVO Discretion.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: Clarify the meaning of Repurchase Agreement in the Derivatives Transaction Definition for Funds in Part Three of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*

DATE: April 28, 2023

Summary: In 2021 the Task Force adopted amendments to the NAIC Fund Lists section of the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "Purposes and Procedures Manual") to provide greater clarity and predictability regarding the acceptable use of derivatives in funds and permit funds greater flexibility in their use of derivatives while maintaining limits on funds' use of leverage. The SVO now proposes a new amendment to clarify which side of a repurchase agreement constitutes a derivative transaction for purposes of the section.

The definition "Derivatives Transaction" in the Purposes and Procedures Manual was modeled after the SEC definition in Rule 18f-4 under the Investment Company Act of 1940. The Purposes and Procedures Manual definition reads:

> Derivatives Transaction – means: (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("*derivatives instrument*"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; (2) any short sale borrowing; and (3) *any reverse repurchase agreement or similar financing transaction* [Italics added for emphasis].

One purpose of the original amendment was to limit the use of leverage by funds and, therefore, "Derivative Transactions" encompasses instruments pursuant to which a fund may be required to make a future payment of cash or other assets. Likewise, the inclusion of "reverse repurchase agreements" was intended to capture arrangements by which the fund would owe a future cash payment to the counterparty.

According to the SEC definition in the Rule 18f-4 adopting release, "In a reverse repurchase agreement, a fund transfers a security to another party in return for a percentage of the value of the security. At an agreed-upon future date, the fund repurchases the transferred security by paying an amount equal to the proceeds of the initial sale transaction plus interest." However, according to SSAP No. 103R - Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, "Reverse repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date." The SSAP No. 103R reverse repurchase agreement definition is the opposite of the SEC definition. According to SSAP No. 103, "Repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date." The SAPP No. 103R definition of repurchase agreement matches the SEC definition of reverse repurchase agreement, in which the fund is obligated to make a repurchase payment at a later date.

Recommendation: To maintain consistency between the Purposes and Procedures Manual and SSAP No. 103R and eliminate any misconception that a fund cannot be the purchaser of securities/lender of cash, the SVO proposes the following changes to the NAIC Fund Lists section of the Purposes and Procedures Manual. 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 2023 P&P Manual format.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

NAIC FUND LISTS

. . .

REQUIRED DOCUMENTATION, ANALYTICAL PROCEDURES AND ELIGIBILITY CRITERIA

. . .

Definitions

. . .

293. **Derivatives Transaction** – means: (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; (2) any short sale borrowing; and (3) any ~~reverse~~ repurchase agreement under which the fund sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date, or similar financing transaction.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-05-15 Interim meeting/03-Funds Rep Derivatives/2023-006-01 PP Manual Amend - Funds_Repos.docx