**THE NAIC SECURITIES VALUATION OFFICE**

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**INTRODUCTION**

One important component of the national system of state-based insurance regulation is careful monitoring of the investments insurers hold, which enables them to make good on the promises they make to their policyholders. The purpose of this article is to explore one of the many tools insurance regulators use to assist them with this important function. It focuses on the Securities Valuation Office (SVO), one of three groups within the NAIC Capital Markets & Investment Analysis Office. Located in New York City, the SVO is responsible for the day-to-day credit quality assessment and valuation of debt securities owned by state-regulated insurers.

Insurers are obligated to report ownership of securities to the SVO when such securities are required to be reported in the NAIC financial statements. All long-term bonds, preferred stocks and common stocks held by insurers are required to be reported in Schedule D. Separate reports of each are required for insurer holdings at the end of each year. Other schedules show long-term bonds and stocks acquired during the current reporting year—all long-term bonds and stocks sold, redeemed or otherwise disposed of during the current year, and all long-term bonds and stocks acquired during the year and fully disposed of during the current year. All other long-term invested assets are reported in Schedule BA. All short-term investments are reported in Schedule DA.

The SVO staff evaluates these securities for the purpose of assigning NAIC-SVO credit quality designations (NAIC designations) and/or unit price. These designations and unit prices are produced solely for the benefit of state insurance regulators, who may use them as part of their monitoring of the financial condition of domiciliary insurers. A domiciliary insurer is an insurer who maintains its principle office in the state or jurisdiction (known as the domestic regulator). An insurer can be licensed in many jurisdictions; but, it can only be a domiciliary insurer in one jurisdiction.

**COMPARISON TO OTHER TYPES OF CREDIT RATING ORGANIZATIONS**

There is a tendency for people to think of all credit rating organizations as performing the same basic functions. There are several well-known private credit rating organizations called Nationally Recognized Statistical Rating Organizations (NRSROs). The U.S. Securities and Exchange Commission (SEC) is primarily responsible for enforcement of federal securities laws and regulating the securities industry. Among the agency’s many duties is designation of the NRSROs. An NRSRO is a credit rating agency that the SEC allows other financial firms to use for some regulatory purposes, such as measuring capital requirements or for insurers, ascertaining the strength of assets held in reserve for future claims.

There are currently nine firms designated by the SEC as NRSROs. They are:

- Standard & Poor’s (S&P)
- Moody’s Investors Service
- Fitch Ratings
- Kroll Bond Rating Agency
- A.M. Best Company
- Dominion Bond Rating Service Ltd.
- Japan Credit Rating Agency Ltd.
- Egan-Jones Rating Company
- Morningstar Inc.

The NRSROs most visible in the insurance sector are A.M. Best, S&P, Moody’s and Fitch. It is important to note not all of the NRSROs provide ratings for U.S. insurers. Further, not all rating agencies providing ratings to insurers are designated by the SEC as an NRSRO. An example of a non-NRSRO providing insurer financial strength ratings is Demotech Inc. Demotech provides ratings to property and casualty insurers, title insurers, health insurers, risk retention groups and self-funded entities.

The purpose of a NRSRO designation is for the convenience of the public, regulators and regulated entities. It helps banks, broker-dealers and insurers meet capital requirements. If a financial institution is invested in highly liquid, safe securities, less capital is needed to meet financial obligations. In the banking sector, it helps guard against a run on the bank. In the insurance sector, it is a matter of solvency protection.

Unlike the ratings of NRSROs, NAIC designations are not produced to aid the investment decision-making process of the public or institutional investors. The purpose of the NAIC designation is to assist financial regulators with their evaluation of the level of confidence the regulator should have in the assets held by insurers. Coupled with laws requiring insurers to invest conservatively, the NAIC designations allow the financial regulator to evaluate whether the insurer has sufficient, conservatively invested assets to meet its obligations to policyholders. Therefore, NAIC des-

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ignations are not suitable for use by anyone other than insurance regulators.

**The NAIC Designation Process**

The SVO staff provides technical advice to the NAIC Valuation of Securities (E) Task Force, a subgroup of the Financial Condition (E) Committee. The SVO also supports other NAIC task forces and working groups addressing insurer invested assets.

The SVO is comprised of 35 investment professionals who assess, at least annually, the credit risk of certain unrated investments owned by insurers. The SVO staff assigns an NAIC designation (1 through 6), a measure of credit risk, to investments required to be filed with the NAIC. In 2015, the SVO staff received securities filings from 1,401 insurers. These filings covered 12,997 securities with an insurer total carrying value of approximately $560 billion. The vast majority of these filings consist of unrated bond debts issued by U.S. corporations, otherwise known as “true private placements.” The SVO staff also translates credit ratings from NRSROs to equivalent NAIC designations. Insurers owning assets rated by NRSROs are not required to file the assets with the NAIC for rating purposes.

This capability allows financial regulators to assess investment credit risks of unrated investments through their own independent, supervisor-driven process instead of relying exclusively on NRSROs. The NAIC designations and other analysis produced by the SVO staff are used in supervisory processes to monitor insurers, including the appropriateness of the RBC investment charges. Without an NAIC designation, an insurer would be reluctant to invest in an unrated security because of the potential for the security to not be allowed as an admitted asset. The SVO derives its authority from state investment laws and reports to the Valuation of Securities (E) Task Force.

**Comparison of NAIC Designations and NRSRO Credit Ratings**

An NRSRO credit rating and an NAIC designation are not identical. A credit rating is a communication between an issuer, a credit rating agency and investors. The purpose of that communication is to provide investors with the NRSRO’s opinion as to the issuers and/or the issues’ credit risk. An issuer wanting a credit rating hires an NRSRO to perform the analysis necessary to provide the credit rating to the issuer for a fee, with the understanding the issuer will use it to communicate with the market. The expectation is investors will use such a rating in their analysis of the issuer and the particular financial instrument the issuer is proposing to sell. Accordingly, the issuer effectively needs to have a rating from a trusted source in order to sell the security to investors.

An issuer cannot obtain an NAIC designation from the SVO. Only U.S. insurers can submit a request for an NAIC designation. To receive an NAIC designation, an insurer has to first own the security—in other words, an investor has already made the decision to purchase the security. An NAIC designation is a communication between the SVO staff and the state insurance financial regulator. The purpose of the communication is to convey an independent opinion of the quality of the investment the insurer purchased.

**Insurer Reporting Requirements and Use of Designations**

All insurers owning the same security are required to use the same NAIC designation for official reporting in annual financial statements to their state insurance regulator. The designation is also used in the NAIC accounting valuation rules under the Statutory Statements of Principle (SSAP)—including, SSAP No. 26—Bonds, SSAP No. 30—Unaffiliated Common Stock and SSAP No. 32—Preferred Stock—and to determine the accounting practices to be followed for modeled and non-modeled residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) under SSAP No. 43R—Loan-Backed and Structured Securities. NAIC designations are also used to establish RBC and investment categories under state investment laws, which limit the type and amount of admitted assets that can be invested in certain designation grades (e.g., non-investment grade).

Insurers access the designations using the NAIC Automated Valuation Service (AVS+) system. The AVS+ is a Web-based application that allows insurers to maintain a portfolio of securities’ information with the NAIC. For each security in an insurer’s portfolio, the application provides the NAIC designation and review date, among other data. This portfolio of information can then be downloaded and exported into software applications that facilitate the preparation of the NAIC annual and quarterly statements filed with the NAIC and state insurance departments.

The NAIC designations are maintained within proprietary NAIC systems. Insurers are allowed to access the system for the sole purpose of reporting the designations to regulators. The only exception is access provided to academics under a

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license. The NAIC allows non-U.S. insurers access to AVS+ information through an individual look-up agreement. While general access to the AVS+ system is limited, an insurer’s public statutory financial statements contain the designation for the assets owned by the insurer. The NAIC established the access parameters of the NAIC designations to reflect the purpose for which they were created—assessing the credit risk of insurers’ investments as part of the regulatory financial solvency monitoring framework.

As discussed previously, while credit ratings and NAIC designations may seem similar, there are important distinctions. An investor that is not a U.S. insurer who obtains and uses an NAIC designation will find that it has differences compared to a credit rating because it was not produced for the same reason or for the same purpose. NAIC designations are monitored on a different basis than credit ratings. An NAIC designation also reflects perspectives unique to the objectives of the NAIC and state insurance regulators, including: 1) whether it is an admitted asset; 2) whether it qualifies as an investment eligible to receive a designation under the SSAPs; 3) whether it contains additional non-payment risks; and 4) a variety of other nuances tied to insurers’ regulatory financial solvency and reporting concerns.

### Potential International Aspects of NAIC Designations

Some have asked whether NAIC designations could be used to satisfy financial regulatory requirements in other countries. Generally speaking, the U.S. issuer of the private placement would have to abide by the laws of the non-U.S. insurer’s home country. In other words, it must either register the offering or abide by the rules governing an exemption from registration in that country. If that same security were offered in either country, and done so in accordance with the laws of both, then it is possible that a non-U.S. insurer could own the same security as a U.S. insurer.

However, as a practical matter, costs and other complexities make it unlikely that a U.S. private placement issuer has the incentive to make the opportunity available to investors in other countries. In this regard, only a small amount (less than 5%) of the true private placement market is owned by non-U.S. insurers.

The International Association of Insurance Supervisors (IAIS) is exploring the development of a risk-based global insurance capital standard (ICS). There have been discussions about whether the NAIC designation could be used as a measurement tool for the ICS. To date, the use of NAIC designations for such purposes has never been considered by the NAIC members. If the IAIS members wish to move forward with a proposal to use NAIC designations for ICS purposes, the appropriate NAIC committee would need to deliberate on the matter. Under current rules, the NAIC-SVO staff is precluded from performing credit analysis on an unrated security owned by a non-U.S. insurer. Conversely, we are unaware of any other jurisdiction or supervisor that authorizes the use of NAIC designations for any regulatory purpose.

### Summary

The SVO of the NAIC has a long history of serving the needs of U.S. insurers and insurance regulators. State insurance regulators rely on the NAIC designations where there is no alternative means for assessing the credit quality of authorized debt investments. The SVO designation process and product are an integral part of the U.S. insurance regulatory system. If state insurance regulators, working through the NAIC, consider adoption of the IAIS ICS in the future, it is a near certainty that use of NAIC designations would continue. This position is consistent with certain mandates of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act, regarding reduced reliance on external rating agencies for regulatory purposes. For more information, please refer to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) and/or contact NAIC senior management.

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**About the Authors**

Eric Nordman, CPCU, CIE, is the director of the NAIC Regulatory Services Division and the CIPR. He directs the Regulatory Services Division staff in a wide range of insurance research, financial and market regulatory activities, supporting NAIC committees, task forces and working groups. He has been with the NAIC since 1991. Prior to his appointment as director of the Regulatory Services Division, Mr. Nordman was director of the Research Division and, before that, the NAIC senior regulatory specialist. Before joining the NAIC, he was with the Michigan Insurance Bureau for 13 years. Mr. Nordman earned a bachelor’s degree in mathematics from Michigan State University. He is a member of the CPCU Society and the Insurance Regulatory Examiners Society.

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1 Access provided to academics under a license includes the same restrictions imposed on insurers and their third-party administrators (TPAs) and to insurer investment managers.
2 This agreement provides an insurer with up-to 50 CUSIPs (assigned security numbers) for a nominal per-CUSIP fee.
ABOUT THE AUTHORS (CONT’D)

Ramon Calderon joined the NAIC in August of 2009 to serve as Director. Prior to joining the NAIC, he served as Deputy Commissioner, Financial Surveillance Branch, for the California Department of Insurance. As a regulator, Mr. Calderon chaired the NAIC’s International Solvency and Accounting Working Group, among other NAIC working groups. In his 30+ years of service with the California Department of Insurance, Mr. Calderon developed expertise in solvency regulation with an emphasis on insurance accounting and business restructurings. He advised the California Insurance Commissioner on a wide range of financial surveillance issues, and served in the capacity of Deputy Commissioner until his departure from the California Department of Insurance in August of 2009.

In his current role at the NAIC, Mr. Calderon is active in international matters and works closely with state insurance regulators and the ComFrame Development and Analysis (G) Working Group (CDAWG) members, and is active with the International Association of Insurance Supervisors (IAIS). He is a member of the IAIS Capital, Solvency and Field Testing Working Group and the Insurance Groups Working Group.

Jeff Johnston oversees all aspects of the NAIC’s financial regulatory services, including the Securities Valuation Office and the Structured Securities Group located in New York City. He provides technical assistance to the NAIC’s members and NAIC staff engaged with federal and international groups with an interest in the state-based system of financial solvency oversight, as well.

From Jan. 2008 to Jan. 2012, Mr. Johnston served as the President of the insurance regulatory consulting firm of Rector & Associates, Inc. In that role, he provided consulting services to insurance companies, insurance regulators, law firms, accounting firms, and others with respect to a wide variety of insurance regulatory issues. For 15 years, Mr. Johnston has held various senior positions with the NAIC, including Chief Financial Officer and Director of Financial Reporting & Analysis. Jeff spent the early part of his career with the Kansas Insurance Department and Employers Reinsurance Corporation, working in various financial positions. Mr. Johnston earned a B.S. in Finance from Emporia State University.
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