

## INVESTMENTS IN MEDIUM AND LOWER GRADE OBLIGATIONS MODEL REGULATION

### Table of Contents

Section 1.	Short Title
Section 2.	Purposes
Section 3.	Preamble
Section 4.	Definitions
Section 5.	Provisions
Section 6.	Effective Date

### Section 1. Short Title

This may be cited as the Investments in Medium Grade and Lower Grade Obligations Regulation.

### Section 2. Purposes

The purposes of this regulation are:

- A. To protect the interests of the insurance-buying public by establishing limitations on the concentration of medium grade and lower grade obligations in which a domestic insurer can invest; and
- B. To implement section [insert section of the insurance law specifying allowable investments] of the insurance law by regulating the acts and practices of domestic insurers with respect to the concentration of investments in medium grade and lower grade obligations.

### Section 3. Preamble

- A. The insurance department is concerned that changes in economic conditions and other market variables could adversely affect domestic insurers having a high concentration of these investments. Accordingly, the Department has concluded that a limitation on the percentage of total admitted assets that a domestic insurer may prudently invest in such obligations is reasonable, necessary and required in order to carry out the Department's responsibilities under relevant statutory law.
- B. The department understands that medium grade and lower grade obligations can have a place in a well-diversified portfolio. However, it is also understood that the special risks associated with these investments require a high degree of management even when they are held within an aggregate limit. While this regulation will leave all domestic insurers with authority to invest a substantial portion of their assets in medium grade and lower grade obligations, the prudent management of the attendant risks will remain an essential element of such investing.

### Section 4. Definitions

As used in this regulation:

- A. "Medium grade obligations" means obligations which are rated three by the Securities Valuation Office of the National Association of Insurance Commissioners.
- B. "Lower grade obligations" means obligations which are rated four, five or six by the Securities Valuation Office of the National Association of Insurance Commissioners.
- C. "Admitted assets" means the amount as of the last day of the most recently concluded annual statement year, computed in the same manner as "admitted assets" in Section [insert section] of the Insurance Law.
- D. "Aggregate amount" of medium grade and lower grade obligations means the aggregate statutory statement value.

- E. "Institution" means a corporation, a joint-stock company, an association, a trust, a business partnership, a business joint venture or similar entity.

**Section 5. Provisions**

- A. A domestic insurer shall not acquire, directly or indirectly, a medium grade or lower grade obligation of an institution if, after giving effect to the acquisition, the aggregate amount of all medium grade and lower grade obligations then held by the domestic insurer would exceed twenty percent (20%) of its admitted assets provided that no more than ten percent (10%) of its admitted assets consists of obligations rated four, five or six by the Securities Valuation Office; and no more than three percent (3%) of its admitted assets consists of obligations rated five or six by the Securities Valuation Office, and no more than one percent (1%) of its admitted assets consists of obligations rated six by the Securities Valuation Office. Attaining or exceeding the limit of any one category shall not preclude an insurer from acquiring obligations in other categories subject to the specific and multi-category limits.
- B. A domestic insurer shall not invest more than an aggregate of one percent (1%) of its admitted assets in medium grade obligations issued, guaranteed or insured by any one institution nor may it invest more than one half of one percent (.5%) of its admitted assets in lower grade obligations issued, guaranteed or insured by any one institution. In no event, however, may a domestic insurer invest more than one percent (1%) of its admitted assets in any medium or lower grade obligations issued, guaranteed or insured by any one institution.
- C. Nothing contained in this regulation shall prohibit a domestic insurer from acquiring obligations which it has committed to acquire if the insurer would have been permitted to acquire that obligation pursuant to this regulation on the date on which the insurer committed to purchase that obligation.
- D. Notwithstanding the foregoing, a domestic insurer may acquire an obligation of an institution in which the insurer already has one or more obligations, if the obligation is acquired in order to protect an investment previously made in the obligations of the institution; provided that all such acquired obligations shall not exceed one-half of one percent (.5%) of the insurer's admitted assets.
- E. Nothing contained in this regulation shall prohibit a domestic insurer from acquiring an obligation as a result of a restructuring of a medium or lower grade obligation already held.
- F. Nothing contained in this regulation shall require a domestic insurer to sell or otherwise dispose of an obligation legally acquired prior to the effective date of this regulation.
- G. The board of directors of a domestic insurance company that acquires or invests, directly or indirectly, more than two percent (2%) of its admitted assets in medium grade and lower grade obligations of an institution, shall adopt a written plan for the making of such investments. The plan, in addition to guidelines with respect to the quality of the issues invested in, shall contain diversification standards including, but not limited to, standards for issuer, industry, duration, liquidity and geographic location.

**Section 6. Effective Date**

This regulation shall take effect on [insert date].

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*Chronological Summary of Action (all references are to the Proceedings of the NAIC).*

*1991 Proc. II 25, 57, 327-328, 329-331 (adopted).*

**INVESTMENTS IN MEDIUM GRADE AND LOWER GRADE  
OBLIGATIONS MODEL REGULATION**

**This chart is intended to provide readers with additional information to more easily access state statutes, regulations, bulletins or administrative rulings related to the NAIC model. Such guidance provides readers with a starting point from which they may review how each state has addressed the model and the topic being covered. The NAIC Legal Division has reviewed each state’s activity in this area and has determined whether the citation most appropriately fits in the Model Adoption column or Related State Activity column based on the definitions listed below. The NAIC’s interpretation may or may not be shared by the individual states or by interested readers.**

**This chart does not constitute a formal legal opinion by the NAIC staff on the provisions of state law and should not be relied upon as such. Nor does this state page reflect a determination as to whether a state meets any applicable accreditation standards. Every effort has been made to provide correct and accurate summaries to assist readers in locating useful information. Readers should consult state law for further details and for the most current information.**

**INVESTMENTS IN MEDIUM GRADE AND LOWER GRADE  
OBLIGATIONS MODEL REGULATION**

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**INVESTMENTS IN MEDIUM GRADE AND LOWER GRADE  
OBLIGATIONS MODEL REGULATION**

**KEY:**

**MODEL ADOPTION:** States that have citations identified in this column adopted the most recent version of the NAIC model in a **substantially similar manner**. This requires states to adopt the model in its entirety but does allow for variations in style and format. States that have adopted portions of the current NAIC model will be included in this column with an explanatory note.

**RELATED STATE ACTIVITY:** Examples of Related State Activity include but are not limited to: older versions of the NAIC model, statutes or regulations addressing the same subject matter, or other administrative guidance such as bulletins and notices. States that have citations identified in this column **only** (and nothing listed in the Model Adoption column) have **not** adopted the most recent version of the NAIC model in a **substantially similar manner**.

**NO CURRENT ACTIVITY:** No state activity on the topic as of the date of the most recent update. This includes states that have repealed legislation as well as states that have never adopted legislation.

NAIC MEMBER	MODEL ADOPTION	RELATED STATE ACTIVITY
Alabama	NO CURRENT ACTIVITY	
Alaska	ALASKA ADMIN. CODE tit. 3 §21.231 (2001).	
American Samoa	NO CURRENT ACTIVITY	
Arizona		ARIZ. REV. STAT. ANN. § 20-540 (1954/1998).
Arkansas	ARK. CODE ANN. § 23-63-805 (1993/2015).	ARK. CODE R. § 36 (1994).
California	CAL. INS. CODE § 1196.1 (1991).	
Colorado	COLO. REV. STAT. § 10-3-215.5 (1992).	
Connecticut		CONN. GEN. STAT. §§ 38a-102b to 38a-102c (1991).
Delaware	NO CURRENT ACTIVITY	
District of Columbia	NO CURRENT ACTIVITY	
Florida		FLA. STAT. 625.305 (1989/1993).
Georgia	NO CURRENT ACTIVITY	
Guam	NO CURRENT ACTIVITY	
Hawaii	NO CURRENT ACTIVITY	
Idaho	NO CURRENT ACTIVITY	
Illinois		215 ILL. COMP. STAT. 5/126.10 (1997).

**INVESTMENTS IN MEDIUM GRADE AND LOWER GRADE  
OBLIGATIONS MODEL REGULATION**

<b>NAIC MEMBER</b>	<b>MODEL ADOPTION</b>	<b>RELATED STATE ACTIVITY</b>
Indiana		IND. CODE § 27-1-12-2 (1991).
Iowa	IOWA ADMIN. CODE r. § 191-5.32 (1992).	
Kansas	KAN. STAT. ANN. §§ 40-2a27 to 40-2b28 (1992/2005).	
Kentucky		KY. REV. STAT. ANN. §403 (2000).
Louisiana	NO CURRENT ACTIVITY	
Maine		ME. REV. STAT. ANN. tit. 24-A, § 1156 (1987/1993).
Maryland		MD. CODE REGS. §§ 31.05.06.01 to 31.05.06.07 (1990/1994).
Massachusetts	MASS. GEN. LAWS ANN. ch. 175, § 63A (1993).	
Michigan		MICH. COMP. LAWS § 500:922 (1956/1991).
Minnesota		MINN. STAT. § 60A.11 (1991).
Mississippi	NO CURRENT ACTIVITY	
Missouri	MO. REV. STAT. § 375.1075 (1991).	
Montana	MONT. CODE ANN. § 33-12-202 (1999/2001).	
Nebraska		NEB. REV. STAT. § 44-5115; § 44-5152 (1991/1997).
Nevada	NO CURRENT ACTIVITY	
New Hampshire	NO CURRENT ACTIVITY	
New Jersey	NO CURRENT ACTIVITY	
New Mexico	NO CURRENT ACTIVITY	
New York	N.Y. COMP. CODES R. & REGS. tit. 11, §§ 176.1 to 176.4 (1987/1991) (Regulation 130).	
North Carolina		N.C. GEN. STAT. § 58-7-170 (1991/1993).
North Dakota	NO CURRENT ACTIVITY	

**INVESTMENTS IN MEDIUM GRADE AND LOWER GRADE  
OBLIGATIONS MODEL REGULATION**

<b>NAIC MEMBER</b>	<b>MODEL ADOPTION</b>	<b>RELATED STATE ACTIVITY</b>
Northern Marianas	NO CURRENT ACTIVITY	
Ohio	NO CURRENT ACTIVITY	
Oklahoma	NO CURRENT ACTIVITY	
Oregon	OR. ADMIN. R. § 836-33-120 (1992).	
Pennsylvania	NO CURRENT ACTIVITY	
Puerto Rico	NO CURRENT ACTIVITY	
Rhode Island	NO CURRENT ACTIVITY	
South Carolina	NO CURRENT ACTIVITY	
South Dakota	S.D. CODIFIED LAWS §§ 58-27-89 to 58-27-102 (1992).	
Tennessee		TENN. CODE ANN. § 56-3-303; § 56-3-402 (1985).
Texas		TEX. INS. CODE ANN. § 3.33 (1985/1997) (L/H).
Utah	NO CURRENT ACTIVITY	
Vermont	93 VT. CODE R. § 3 (1993).	
Virgin Islands	NO CURRENT ACTIVITY	
Virginia	VA. CODE ANN. § 38.2-1401; § 38.2-1411.2 (1992).	
Washington		WASH. REV. CODE ANN. § 48.13.071 (2011)
West Virginia	NO CURRENT ACTIVITY	
Wisconsin	NO CURRENT ACTIVITY	
Wyoming	NO CURRENT ACTIVITY	

**INVESTMENTS IN MEDIUM GRADE AND LOWER GRADE  
OBLIGATIONS MODEL REGULATION**

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## INVESTMENTS IN MEDIUM GRADE AND LOWER GRADE OBLIGATIONS MODEL REGULATION

### Proceedings Citations

Cited to the Proceedings of the NAIC

#### Section 1. Short Title

In earlier drafts reviewed the term used by the drafters was medium and lower quality obligations. Before final adoption the current wording was substituted. **1991 Proc. IA 231.**

#### Section 2. Purpose

A. A life insurance association agreed with the position of the NAIC in that they stated that they supported the imposition of reasonable limitations upon the quality of investments made by the life insurance industry, as well as on the amounts of investments in specific categories. **1991 Proc. IIA 336.**

#### Section 3. Preamble

The Financial Condition Subcommittee discussed appropriate regulation of high yield investments in conjunction with the downturn being experienced in the non-investment grade bonds market. The chair announced the appointment of a working group to consider development of a model investment regulation using some type of overall limitation or diversification approach or a combination of the two. **1990 Proc. II 259.**

#### Section 4. Definitions

A. The first task of the working group developing a model regulation was to develop a clearer definition of a high yield security. This would include a review of the procedures of the NAIC Securities Valuation Office (SVO) and how the SVO's designations impact the annual statement. The objective was to enable a person to look at an insurer's annual statement and readily assess the quality of the insurer's bond portfolio. Only after this first phase was completed could work begin on a model investment regulation. **1990 Proc. II 259.**

By June of 1990 the working group had completed the first phase of its work, and the NAIC adopted a new structure for SVO designations. Then the group was ready to consider caps for high yield securities. **1990 Proc. II 205.**

#### Section 5. Provisions

A. As the working group began drafting a limitation provision for high risk securities, it received an insurance industry proposal for consideration. An association had drafted a bill which did not impose a cap on high yield bond investments. Instead it imposed strict reporting, diversification, research and asset/liability matching requirements on all insurers investing in high yield securities. **1991 Proc. IA 234-235.**

When the drafters were considering an appropriate level for the limitation, several representatives from states with limits shared their experience. One state had had a limitation in place for some time, and only one company had problems with the limitation. Another reported the limitation in his state had been adopted so recently its effect was not yet known. A third state indicated a need to redefine investment grade under its statute because the bond designations had changed. **1991 Proc. IA 233.**

Concern was expressed by some that by including inside limits, a state would be micromanaging. **1991 Proc. IA 233.**

Before adoption of the model, one commissioner suggested adding another sentence to Subsection A. It would have given the commissioner authority to permit investments of another 10% of admitted assets in obligations rated three and four. **1991 Proc. IIA 336.** Discussion followed where the working group chair noted that commissioner discretion had been removed from the model draft to promote uniformity. A 30% investment in medium grade and lower grade obligations would be

**INVESTMENTS IN MEDIUM GRADE AND LOWER GRADE  
OBLIGATIONS MODEL REGULATION**

**Proceedings Citations**

Cited to the Proceedings of the NAIC

**Section 5A (cont.)**

approximately five times capital and surplus for the average life insurer. In light of the fact that one state had a 15% cap and another 10%, one commissioner expressed the opinion that 20% was not inappropriate. The motion to add the sentence was defeated. **1991 Proc. IIA 326-327.**

A proposal from interested parties suggested that some insurers had demonstrated significant expertise in making such investments, so they ought to be able to petition the commissioner for approval to make investments otherwise restricted. **1991 Proc. IIA 333.**

The proposal contained a limitation of 35% of investments in medium and lower quality obligations. **1991 Proc. IIA 333.**

B. After discussion of the exposure draft, the working group decided to add limits for bond holdings from a single issuer to 1% of admitted assets for class 3 bonds and to .5% for classes 4, 5 and 6. **1991 Proc. IIA 331.**

A proposal from interested parties limited investment in obligations rated 4, 5 and 6 to 15% of admitted assets, with no more than 1% of assets in obligations in category 6. Their proposal limited investments in one insurer to 2% of admitted assets. **1991 Proc. IIA 333.**

F. One state regulator pointed out that his state's regulation was prospective in nature. It did not require divestment of securities, but rather did not allow additional purchases of high yield securities until an insurer's holdings were below the limitations level. **1991 Proc. IA 233.** A similar concept was included in the model adopted by the NAIC. **1991 Proc. IIA 330.**

In the last drafting session before adoption the working group considered removing the "grandfathering" of existing holdings in medium and lower grade obligations. However, the regulators decided to retain the provisions. **1991 Proc. IIA 331.**

The proposal from interested parties went one step further, allowing a domestic life insurer to buy replacement investments if they maintained records to demonstrate that the acquisition did not cause the percentage of medium and lower quality obligations to increase above the company's historical percentage of such holdings prior to the effective date of the regulation. **1991 Proc. IIA 333.**

G. Interested parties suggested that the draft include a threshold of 2% of admitted assets before an investment plan was required. The working group agreed with that recommendation. **1991 Proc. IIA 331.**

**Section 6. Effective Date**

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*Chronological Summary of Actions*

*June 1991: Adopted model*