NAIC National Association of Insurance Commissioners
& The Center for Insurance Policy and Research

MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office
Susan Ding, Credit Analyst Supervisor/Team Leader, NAIC Securities Valuation Office (SVO)

CC: Dan Daveline, Director, NAIC Financial Regulatory Service

DATE: April 27, 2017

RE: Proposed Modification to Adopted Text for the List of Qualified U.S. Financial Institutions

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1. **Issue** – On April 17, James McIntyre and Chrys D. Lemon of McIntyre & Lemon PLLC, a law firm in Washington DC, contacted the SVO. They expressed concern that the financial metrics that would be used to monitor the credit quality of financial institutions suggested a financial institution could be removed from the list even if it was still rated at the minimum credit rating. The text in question sought to explain that on an annual basis, the SVO would create an "average" financial profile of financial institutions in the minimum credit rating grade as a tool to monitor the financial institutions on the list. In that context, "average" does not imply the financial institutions must have an "average" financial profile for the minimum grade. Nevertheless, the text can be read to mean that the SVO would ignore that the minimum credit rating encompasses a range of financial profiles and insist that the financial institution meet the metrics for an average institution. This inaccurate interpretation is assisted by expressing specific financial values associated with the "average" as an absolute: i.e. "total assets must remain at greater than $**55 billion**" because that fixates the reader on a metric that may not be met by a bank that nevertheless will continue to be rated at the required minimum credit rating. The comment illustrates that it is preferable to alter the communication away from a description of what benchmarks the SVO may create to a more direct statement of the objective of the monitoring effort. The second issue of interpretation occurs because the same symbols are used in two separate sections of a description of the monitoring performed for progressively lower ratings, which can be readily resolved by using an alternate expression. The SVO proposes the changes shown below to clarify both communications. The SVO requests that this proposed amendment be exposed for a 30-day public comment period.

2. **Proposed Changes** – The SVO recommends revisions to adopted text shown below to address the interpretational issues that have been identified.

Part Six – List of Qualified U.S. Financial Institutions
(Issuers of Letters of Credit as Collateral in Reinsurance Arrangements)

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Section 6. SVO Monitoring of Movements in the Credit Quality of Financial Institution on the List of Qualified U.S. Financial Institutions

…

b. **Outline of Methodology** – On a quarterly (or semi-annual) basis, the SVO shall:

…

~~(ii) Determine and evaluate the following five primary data points and ratios. (Annually, the NAIC SVO will review industry data to determine if these benchmarks should be adjusted to reflect changes in market conditions.)~~

- ~~Total assets must remain at greater than $55 billion.~~
- ~~Total equity capital must remain at greater than $5 billion.~~
- ~~Annualized cash from operations must remain at greater than $2 billion.~~
- ~~Debt to capital ratio must remain below 55%.~~
- ~~EBITDA to interest coverage ratio must remain at greater than 8.5 times.~~

The SVO will compare the results obtained for the metrics discussed above to the ranges published by nationally recognized statistical rating organizations (NRSROs) for the minimum NAIC credit rating requirement (Baa3/BBB-) as they pertain to: total assets~~;~~, total equity capital~~;~~, annualized cash from operations~~;~~, debt to capital and EBITDA to interest coverage. This information will be used to estimate the likelihood that the financial institution will drop below the required minimum credit rating.

Note: The financial metrics (i.e., ratios and data points) for specific credit ratings are published by NRSROs and may be adjusted from year to year by the NRSROs to relate changes in market conditions to the financial profiles associated with their credit ratings.

c. Notice of Credit Deterioration – The SVO shall provide notice to the NAIC Reinsurance (E) Task Force and state insurance regulators more generally and to insurers about the credit quality of financial institutions on the List of Qualified U.S. Financial Institutions as described below.

(i) If a financial institution is rated by an NRSRO at "A-/A3" or better and the SVO determines that a financial institution no longer meets one or more of the financial metrics ~~standards~~ specified above, the SVO will monitor the institution to ~~determine~~ assess the likelihood of~~if~~ the NRSRO to take~~s~~ a potential negative~~ny~~ rating action against the institution.

(ii) If the SVO determines that a financial institution on the List of Qualified U.S. Financial Institutions rated "BBB+/Baa1or below but not lower than BBB-/Baa3" ~~below "A-/A3"~~ by an NRSRO no longer meets one or more of the financial metrics ~~standards~~ specified above, or that it has been placed on Negative Outlook or Negative Watch by an NRSRO, the SVO shall perform a more detailed review of the financial condition of the institution.

If the SVO determines that the noted credit deterioration suggests that the financial institution may soon no longer meet the required minimum, the SVO will place the name of the financial institution on its ~~the~~ Watch List. If the name of the financial institution is placed on the SVO Watch List, ~~, signifying that~~ the financial institution will not be allowed to renew participation on the financial institution list for the next year. ~~, and until the financial institution's credit rating is restored to BBB/Baa or higher with a stable outlook~~

(iii) If a financial institution on the List of Qualified U.S. Financial Institutions is downgraded below "BBB-/Baa3" by an NRSRO, the SVO shall remove the name of the financial institution from the List of Qualified U.S. Financial Institutions.

(iv) A financial institution whose name is deleted from the List of Qualified U.S. F~~f~~inancial I~~i~~nstitutions ~~list~~ because its NRSRO credit rating dropped below the minimum credit rating may renew participation on the financial institution list when the financial institution's credit rating is restored to BBB-/Baa3 or higher with a stable outlook.

