



**MEMORANDUM**

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

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office

CC: Charles Therriault, Director, NAIC Securities Valuation Office  
Julie Gann, Senior Manager, NAIC Financial Regulatory Services

DATE: January 9, 2017

RE: Proposed Amendment to the *Purposes and Procedures of the NAIC Investment Analysis Office* (P&P Manual) to Delete the Insurer Certification Procedure and Modify the Use of Administrative Symbol **Z**

**1. Introduction** – In 2015, the Task Force agreed to move the certification procedure component of the 5\*/6\* rule out of Part Two, Section 5 of the P&P Manual and into a General Interrogatory.<sup>1</sup> The Task Force referred a form of Interrogatory to the Blanks (E) Working Group on July 18, 2016, which the Working Group adopted at the 2016 Fall National Meeting, effective with the 2017 annual statement instructions. The proposed amendment would delete the certification procedure from the P&P Manual and modify how the administrative symbol **Z** is used in Task Force operations, as more fully discussed below.

**2. The Administrative Symbol Z and the Z Rule** – The Z symbol is used by an insurer to self-designate a security purchased too late during the year to obtain an NAIC Designation from the SVO for year-end reporting. The elimination of the certification procedure from the P&P Manual does not eliminate the need for insurer self-designation over the year-end period.<sup>2</sup> This use of the **Z** symbol should be retained as necessary to Task Force operations. The 5\*/6\* rule limited the use of the **Z** administrative symbol to the first year and required “Z securities” to be filed for a designation or for a 5\* in the second and subsequent years. Elimination of the certification procedure from the P&P Manual eliminates the requirement that the insurer file **Z** securities with the SVO for a 5\* in the second year.<sup>3</sup> This use of the **Z** symbol is no longer relevant to Task Force operations and should be eliminated. The 5\* rule provides that an insurer that filed a **Z** security with the SVO for an analytically determined designation in year two, which the SVO was unable to provide for year-end, may continue to self-

<sup>1</sup> Part Two, Filing with the SVO, SECTION 5. SPECIAL REPORTING INSTRUCTION a) NAIC Designations Related to the Special Reporting Instruction – NAIC 5\* is assigned ... to certain obligations when an insurer certifies: (1) that documentation necessary to permit a full credit analysis of a security does not exist and (2) the issuer or obligor is current on all contracted interest and principal payments and (3) the insurer has an actual expectation of ultimate payment of all contracted interest and principal. ... NAIC 5\* Designation is also assigned to certain securities pursuant to policy decisions adopted by the Valuation of Securities Task Force ...

<sup>2</sup> Part Two, Filing with the SVO – SECTION 7. WHEN TO USE THE SECURITIES ACQUISITION REPORT (SAR) – A security issued by an entity unaffiliated with the reporting company is reported by creating, completing and submitting the SAR form. The reporting insurance company must submit the SAR to the SVO not later than 120 days after the purchase of the security. Part One, Purposes, General Policies and Instructions to the SVO, Section 3 Internal Administration b) Definitions ... (v) SVO Administrative Symbols ... **Z** means that the NAIC Designation reported by the insurance company was not derived by or obtained from the SVO, but has been determined analytically by a reporting insurance company. A security designated with a **Z** must be submitted to the SVO for valuation within 120 days of the date the security was acquired. The **Z** symbol should not be used for securities that are exempt from filing with the SVO pursuant to Part Two, Section 4(d) of this Manual.

<sup>3</sup> Part Two, Filing with the SVO Section 5 Special Reporting Instruction b) Use of the Administrative Symbol **Z** – An insurance company may report a security with a “Z” suffix on its Schedule D for up to a year after purchase. For the second year after purchase, and thereafter, the insurance company may not report a security with a “Z” suffix except as noted in Section 5(d) of this Part below. The insurer shall either file the security and appropriate documentation with the SVO to obtain an NAIC Designation, file a Principal and Interest Certification Form to obtain an NAIC 5\* Designation or report the security with an NAIC 6\* Designation on its Schedule D (collectively, the “5\*/6\* Rule”).

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designate using the Z for the second year.<sup>4</sup> The elimination of the certification procedure from the P&P Manual does not eliminate the possibility that the SVO will have unanalyzed securities at year-end. However, the better approach, recommended in the “rules modernization” proposals, is for the SVO to extend the Designation for such securities into the new year and prioritize that population to be designated first in the new year. Although this aspect of Task Force operations will remain valid, the use of the Z symbol is no longer efficient and should be replaced with the identified mechanism.<sup>5</sup>

### 3. Proposed Amendment to the P&P Manual

#### Section 5. Special Reporting Instruction

##### a) NAIC Designations Related to the Special Reporting Instruction

NAIC 5\* GI is permitted to be assigned by insurance companies to the SVO to certain obligations that meet all of the following criteria and are not captured in Section 5 (b): (1) ~~that~~ documentation necessary to permit a full credit analysis of a security does not exist; ~~and~~ (2) the issuer or obligor is current on all contracted interest and principal payments; and (3) the insurer has an actual expectation of ultimate payment of all contracted interest and principal. An insurance company that self-assigns a 5\*GI 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 to perform a full credit analysis for a security does not exist, 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\*.

<sup>4</sup> Part Two, Filing with the SVO Section 5 Special Reporting Instruction d) Exemption from Application of the 5\*/6\* Rule – The 5\*/6\* Rule will not be held to apply to a security that has been: (i) Filed in a timely manner after purchase of such security (that is, within 120 days); and (ii) For which a complete filing (including any annual filing that would have been required if the original filing had received an NAIC Designation) is received by the SVO by September 1, if the SVO has not reviewed such security by year-end. For these securities, a “Z” suffix is reported on Schedule D.

<sup>5</sup> The concept is first discussed in the memorandum dated January 13, 2015, entitled “Discussion – Improvements to NAIC Systems and Rules Governing Insurer Filing of Securities with the SVO” presented to the Task Force for the 2015 Spring National Meeting. The relevant paragraph is as follows:

“The Z symbol and process is intended for use at year-end by an insurer that has filed all necessary documentation within 120 days but not received a reply from the SVO by year-end. The Z symbol could instead be assigned by the SVO as part of its year-end process to identify securities the SVO has received in compliance with the filing policies but has not completed its analysis during the year-end process and which the SVO is committed to complete thereafter and disseminate in its Code 99 process.”

After further discussion with the American Council of Life Insurers (ACLI), the Private Placement Investors Association (PPIA) and North American Securities Valuation Association (NASVA), the SVO presented a memorandum dated March 10, 2015, entitled “Outline of Rules and System Changes and Characteristics” in which the concept is presented in fuller terms as follows:

“3. Self-Designation and the Z Symbol – Whenever the SVO is unable to assign an NAIC designation to a security filed by the Sept. 1 deadline, the insurer may self-designate the security and report it with the symbol Z to identify the security was self-designated. Problem – The intent of the above rules was to require insurers to file securities with the SVO or take onerous 5\* treatment for securities not so filed. The September deadline expresses an expectation that the SVO should be able to complete all assessment filed by this date by year end. The problem is that instead of being a deadline applicable only for the Z population, the Sept. 1 deadline has become the effective filing deadline for all securities. This creates an unnecessarily uneven workflow and concomitant workload imbalance for the SVO. Second, the expectation expressed by the Sept. 1 deadline is not linked to resource availability and is, therefore, unworkable. Original SVO Proposal – The SVO recommended that it be the only assignor of the Z symbol to those securities properly filed by insurers but not assigned NAIC designations by the SVO by year-end. Under its proposal, the SVO would extend the designation previously assigned until it can proceed to a current evaluation for these securities. Coupled with other proposed changes in filing rules and/or their allotted time period, the population to which this process would apply should be small. The SVO also proposes that potential resource constraints also be addressed. Under this aspect of the SVO proposal, the Task Force and the SVO director would set an acceptable annual carryover rate that is analyzed the following calendar year. If this rate is significantly exceeded and if the cause is traceable to resource constraints, under a proposed P&P Manual oversight procedure, the Task Force would have responsibility to discuss the need for additional staff with the NAIC Internal Administration (EX1) Subcommittee. This mechanism and approach would eliminate the need for all of the captioned rules, and the filing deadline would be set by reference to the purchase date in a reduced 120-day rule. Current Status of Issue – NASVA and the ACLI support the SVO proposal. However, NASVA and the ACLI request that the Z rule be kept for insurers because it continues to serve historical roles and that a new administrative symbol be created for the SVO. The Task Force has approved this document, permitting its use as a framework for the development of the VISION computer platform.

~~NAIC 6\* is assigned by an insurance company er to an obligation in lieu of reporting the obligation with appropriate documentation and in instances in which he appropriate appropriate documentaion does not exist, but the requirements for an insurance company to assign a 5\* GI are not met. to the SVO for a full credit analysis or filing the certification required for obtaining an NAIC 5\* Designation. This use of an NAIC 5\* Designation is connected with the Special Reporting Instruction contained in Section 5(b) of this Part below.~~

The NAIC 5\* Designation is also is assigned by the SVO to certain securities pursuant to policy decisions adopted by the VOS/TF Valuation of Securities (E) Task Force.

Securities with NAIC 5\* Designations (including NAIC 5\*GI and other 5\* coding variations) are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. ~~Therefore~~ A security assigned an NAIC 5\* Designation ~~should~~ incurs the ~~same~~ regulatory treatment associated with an NAIC 5 Designation. ~~The asterisk (\*) after the quality indicator 5 distinguishes the NAIC 5\* Designation from the NAIC 5 Designation that is only assigned by the SVO after a full credit analysis.~~

~~NAIC 6\* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation to the SVO for a full credit analysis or filing the certification required for obtaining an NAIC 5\* Designation. This use of an NAIC 6\* Designation is connected with the Special Reporting Instruction contained in Section 5(b) of this Part below.~~ An NAIC 6\* Designation is ~~also~~ assigned by the SVO to an obligation that was assigned an NAIC 5\* Designation by the SVO in a given year if no Subsequent Report is received by the SVO. Securities an insurance company previously assigned as NAIC 5\*GI are permitted to subsequently receive this designation if the requirements for an NAIC 5\*GI designation continue to be met.

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 ~~should~~ incurs the ~~same~~ regulatory treatment associated with an NAIC 6 Designation.

The asterisk (\*) after the quality indicator 5 or 6 distinguishes the NAIC 5\* and NAIC 6\* Designation from an NAIC 5 or NAIC 6 Designation ~~that is only assigned by the SVO after a full credit analysis.~~

#### **Special Reporting Instruction—Use of the Administrative Symbol Z Schedule D**

~~An insurance company may report a security with a “Z” suffix on its Schedule D for up to a year after purchase. For the second year after purchase, and thereafter, the insurance company may not report a security with a “Z” suffix except as noted in Section 5(d) of this Part below.~~

~~The insurer shall either file the security and appropriate documentation with the SVO to obtain an NAIC Designation, file a Principal and Interest Certification Form to obtain an NAIC 5\* Designation or report the security with an NAIC 6\* Designation on its Schedule D (collectively, the “5\*/6\* Rule”).~~

~~An insurance company that decides to file a Principal and Interest Certification Form for a security, pursuant to the 5\*/6\* Rule, should do so by October 1.~~

#### **Application of the 5\*/6\* Rule**

~~Insurers are required to apply the 5\*/6\* Rule to all Annual Statements beginning with the 1999 Annual Statement. The 5\*/6\* Rule applies only to securities owned in the prior year. For example, in the 1999 Annual Statement filing, the 5\*/6\* Rule would have applied to securities that had been listed with a “Z” as of December 31, 1998.~~

#### **Exemption from Application of the 5\*/6\* Rule**

~~The 5\*/6\* Rule will not be held to apply to a security that has been:~~

- ~~(i) — Filed in a timely manner after purchase of such security (that is, within 120 days), and~~
- ~~(ii) — For which a complete filing (including any annual filing that would have been required if the original filing had received an NAIC Designation) is received by the SVO by September 1, if the SVO has not reviewed such security by year end.~~

For these securities, a “Z” suffix is reported on Schedule D.

#### **Documentation**

~~Insurance companies are instructed to maintain a record of the purchase and filing dates of the securities they file with the SVO.~~

#### **Use of NAIC 5\* Designation**

~~An insurer may file a Principal and Interest Certification Form with the SVO when it can certify:~~

- ~~(i) — That documentation necessary to permit a full credit analysis of a security does not exist;~~
- ~~(ii) — The issuer or obligor is current on all required interest and principal payments; and~~
- ~~(iii) — The insurer has an actual expectation of ultimate payment of all required interest and principal.~~

~~The SVO may assign the NAIC 5\* Designation to corporate, municipal and to structured securities that have never been rated by an NAIC CRP.~~

~~An NAIC 5\* Designation can only be assigned by the SVO. The SVO shall assign an NAIC 5\* Designation upon a review of a fully completed and executed Principal and Interest Certification Form.~~

~~The submission of the Principal and Interest Certification Form does not preclude the SVO from conducting an analytical review of the security. Upon such review, in cases where assigning an NAIC 5\* Designation appears inconsistent, the SVO shall apply appropriate analytical procedures to assure an accurate designation.~~

~~The SVO is not responsible for assessing the truth or accuracy of the Principal and Interest Certification Forms that are filed by insurers or for monitoring any other aspect of this Special Reporting Instruction.~~

#### **Use of NAIC 6\* Designation**

~~An insurer may assign an NAIC 6\* Designation to corporate and municipal securities and to structured securities that have never been rated by an NAIC CRP.~~

~~The insurer shall assign an NAIC 6\* Designation to a security when:~~

- ~~(i) — The documentation necessary to permit a full credit analysis of a security does not exist;~~
- ~~(ii) — The insurer cannot certify that the issuer or obligor is current on all required interest and principal payments; and~~
- ~~(iii) — The insurer cannot certify that it expects ultimate payment of all interest and principal.~~

~~The SVO may assign a security an NAIC 6\* Designation when the security was assigned an NAIC 5\* Designation in a previous year but no Subsequent Report has been received by the SVO.~~

#### **Unit Price of NAIC 6\* Securities**

~~An insurer that intends to report a security on its annual or quarterly financial statement (NAIC Financial Statement Blank) with an NAIC 6\* Designation and a Unit Price not greater than zero is not obligated to file a Principal and Interest Certification Form for the security with the SVO. An insurer that intends to report a security on its annual or quarterly financial statement (NAIC Financial Statement Blank) with an NAIC 6\* Designation and a Unit Price greater than zero shall file a Principal and Interest Certification Form for the security with the SVO.~~

**Other Permitted Uses of the Principal and Interest Certification Form and the NAIC 5\* and 6\* Designations-SVO Assigned NAIC 5\* and 6\* Designations**

Securities identified below are not permitted use of the insurance company assigned NAIC 5\*GI Designation. Insurance companies holding these securities shall utilize the Principal and Interest Certification Form to Designations from the SVO:

Note: The Principal and Interest Certification Form can be obtained here:

- (i) Corporate Bonds and Preferred Stock with Unaudited Financial Statements  
The Principal and Interest Certification Form and the **NAIC 5\*** Designation may be used in connection with the designation of corporate securities with unaudited financial statements as specified in [Part Three, Section 1\(a\)\(ii\)\(B\) of this Manual](#).
- (ii) Residential Mortgage Backed Security (RMBS)  
The Principal and Interest Certification Form and the **NAIC 5\*** and **6\*** Designations may be used in connection with an RMBS that has never been rated by an NAIC CRP as specified in [Part Seven, Section 6\(a\)\(iv\)\(B\) of this Manual](#).
- (iii) Commercial Mortgage Backed Securities (CMBS)  
The Principal and Interest Certification Form and the **NAIC 5\*** and **6\*** Designations may be used in connection with a CMBS that has never been rated by an NAIC CRP as specified in [Part Seven, Section 6\(a\)\(iv\)\(B\) of this Manual](#).
- (iv) Foreign Securities of Issuers Domiciled with No NAIC CRP Sovereign Rating  
The Principal and Interest Certification Form and the **NAIC 5\*** and **6\*** Designations may be used in connection with reporting foreign securities issued in countries that have not been assigned a sovereign rating by an NAIC CRP as specified in [Part Three, Section 1\(a\)\(ii\)\(D\)\(2\) of this Manual](#).
- (v) Parent-Subsidiary Situations  
The Principal and Interest Certification Form and the **NAIC 5\*** and **6\*** Designations may be used in connection with reporting parent-subsidiary situations as specified in [Part Three, Section 1\(a\)\(ii\)\(E\) of this Manual](#).
- (vi) Military Housing Bonds or Securities Issued On or After Dec. 31, 2009, and Not Rated by an NAIC CRP  
The Principal and Interest Certification Form and the **NAIC 5\*** Designation may be used in connection with the designation of military housing bonds or securities that were issued on or after Dec. 31, 2009, and were not rated by an NAIC CRP pursuant to the policy determination expressed in [Part Four, Section 5\(c\) of this Manual](#).
- (vii) Other Catastrophe-Linked Bonds  
The Principal and Interest Certification Form may be used to report a Catastrophe-Linked Bond that has not been assigned a credit rating by an NAIC CRP and those that have been assigned a credit rating by an NAIC CRP on the basis of a methodology other than that specified in [Part Four, Section 4 \(a\) \(ii\) of this Manual](#).  
  
Catastrophe-Linked Bonds not assigned a credit rating by an NAIC CRP and those assigned a credit rating by an NAIC CRP on the basis of a methodology other than that specified in [Part Four, Section 4 \(a\) \(ii\) of this Manual](#) shall be reported to the SVO and assigned an **NAIC 6\*** Designation by the SVO.

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