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

To: Hon. Dave Jones, Commissioner, California Dept. of Insurance and Chair, Reinsurance (E) Task Force
Dan Schelp, NAIC Managing Counsel; Josh Arpin, Accounting and Reinsurance Policy Advisor, FRS
From: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Bob Carcano, Senior Counsel, Investment Analysis Office
Re: Proposal to Expand the NAIC Bank List to Include Eligible Non-Bank Financial Institutions
Date: February 24, 2016

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1. Introduction – At the request of the Reinsurance (E) Task Force (RTF) the Valuation of Securities (E) Task Force (VOSTF) directed the SVO to develop criteria to include non-bank financial institutions (NBFIs) on the NAIC Bank List that reflected the influence of regulation on financial strength.[1] The SVO reported its research at the VOSTF's 2015 Summer National Meeting and presented its final report at the 2015 Fall National Meeting. The final report was received and released for a 60 day comment period - no comments were received. The report was discussed on a Feb. 22, 2016 conference call. The SVO report and proposal were adopted for the purpose of referral to the RTF.

2. Referral – The SVO proposal is contained in Attachment One of the report. Attachment Two summarizes the issues considered and conclusions reached by the SVO. The full research report follows the summary and other attachments translate NRSRO methodology to show how regulation is reflected in NRSRO credit analysis. If the RTF approves the SVO proposal the VOSTF requests that it recommend that the VOSTF implement the proposal.

3. Synopsis of Proposal - The SVO proposal is built on three core recommendations:

- Today, the credit rating is only used to determine eligibility. The credit rating should be used more fully. This is possible by defining an <u>acceptable credit rating</u> as one: a) issued by an NRSRO; b) derived using a methodology (identified in the P&P Manual) that the SVO confirms evaluates NBFIs and banks against the same analytical framework and standards; c) *comprehensively evaluates the effectiveness of regulation of the specific institution* and d) generates a credit rating for the <u>institution's letter of credit or senior debt obligation</u>.

- NBFIs should be listed because: 1) statistical analysis shows that the historical default rate for banks (1920–2014) and NBFIs (1971–2014) is almost identical; 2) NBFI applicants would be lenders who typically adopt bank business models and 3) NBFIs could only apply if they have been assigned an <u>acceptable credit rating</u>.

- Today the SVO performs a clerical function: it adds banks if they meet a minimum standard and removes them when they don't. SVO should analytically monitor the credit quality of institutions and provide regulators and insurers notice when credit quality deteriorates toward the minimum. This recommendation reflects analysis *that during the most recent financial crisis banks on the list failed at close to a 20 percent rate*.

[1] In 08/2014 the VOSTF asked the RTF if NBFIs should be added to the List to conform to the definition of qualified US financial institution in the NAIC Credit for Reinsurance Model Law. The RTF agreed on 10/29/2014, if SVO found NBFIs were as well regulated as banks. SVO research in a report dated 12/22/2014 confirmed that the definition in the Model Law was consistent with the federal - state banking regulatory process. The SVO research report was presented to the RTF and VOSTF on a call held 02/24/2015 and the report was referred to the RTF and discussed at its 2015 Spring National Meeting. Some RTF members were concerned that bank regulation made banks stronger than NBFIs. RTF asked that SVO develop criteria to include NBFI that considered the role of regulation. The proposal transmitted today responds to this request.