AMERICAN ACADEMY *of* ACTUARIES

June 19, 2012

To: Kevin Fry, Chair, National Association of Insurance Commissioners, Valuation of Securities (E) Task Force

From: The American Academy of Actuaries' Invested Asset Working Group

Subject: Proposed Amendments to the *Purposes and Procedures Manual* to Modernize Classification Methodology

The American Academy of Actuaries[1] Invested Asset Work Group (AIAWG) appreciates the opportunity to comment on the National Association of Insurance Commissioners (NAIC) Securities Valuation Office's (SVO) proposal to NAIC Valuation of Securities (E) Task Force (VOSTF) related to modification of the methodology for assigning classifications to investments and changing how classification decisions are implemented.

While we generally support efforts to review regulatory processes for identifying, reporting, and monitoring investment risks in order to strengthen the regulatory framework, in our review of this specific proposal we cannot support it. The SVO proposal would establish a regulatory process that would give it the authority to establish or modify regulatory processes for certain investment risks (so called "other non-payment risks"), thereby outside the established decision framework that currently operates within the NAIC and state insurance departments.

Specifically, the SVO proposal would authorize and require it to "identify securities that contain …contractual modifications and to quantify the possibility that such contracts will result in a diminution in payment to the insurer so that this can be reflected in the NAIC designation assigned to the security through the application of the notching process…". The proposal introduces the new term "other non-payment risk as the basis for determining if a subscript S should be attached to the NAIC designation for a particular asset". Lastly, the proposal would determine the degree to which the "other non-payment risk" could potentially alter the position of the security within the issuer's capital structure. By "notching" the security, the SVO would prevail over the classification defined in the NAIC's *Practices and Procedures Manual*.

Our major concerns with the proposal include the following:

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

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1. The proposal introduces the term “other non-payment risk” without a clear definition. This lack of clarity, along with the SVO discretion “…to notch an NAIC Designation for an issuer up or down to reflect the position of a specific liability in the issuers capital structure…” will create confusion in implementation and potential conflict with the existing Risk-Based Capital (RBC) structure. For example, the proposal does not reference the prior work done by the Risk Subgroup of the NAIC Invested Asset Working Group. This subgroup, after analyzing all investment risks for fixed income securities, identified the following material risks: event, liquidity, credit, deferral, call, extension, currency and leverage. If the SVO modifies an NAIC designation for other non-payment risks on a discretionary basis it essentially ignores the work of NAIC working groups and does not follow the existing NAIC process for updating regulations.

2. The needs of regulators should drive changes in classification and designation. Classification is not an expression of risk and should be defined according to accounting principles. Classification is defined in the Statutory Statements of Accounting Principles (SSAP) and references the NAIC’s *Practices and Procedures Manual*. NAIC designations were established to facilitate the calculation of RBC and the Asset Valuation Reserve (AVR). The NAIC designations should be based on the investment risks recognized in RBC. If new investment risks are emerging and not recognized in RBC or AVR, then the risk exposure should be quantified and evaluated for inclusion in RBC and AVR. This evaluation of a new investment risk should be conducted through the standing committee structure of the NAIC, including the Capital Adequacy (E) Task Force (CADTF) and the VOSTF where full and open discussions can take place.

3. We believe that a joint effort of the VOSTF and CADTF, such as the C1 Factor Review Subgroup, is a better way to ensure that the “…regulatory objective of classification analysis…” is preserved. The C1 Factor Review Sub Group has been operational since 2011 and is in the early stages of executing its charge. Adopting the SVO’s proposal would be ill-advised and premature given the ongoing work of the joint C1 Factor Review Subgroup.

Conclusion

We have reviewed the SVO’s proposal to the VOSTF for adding granularity to the NAIC designation by adding a subscript S based on the degree of “other non-payment risk”. We support the effort to identify new risks and seek appropriate modifications to the RBC framework, but do not support the SVO’s proposal for the reasons discussed above. The AIAWG and its sister work group, the C1 Work Group, are actively working with the NAIC to review the regulatory identification of investment risks and treatment in the RBC framework. The AIAWG is available to assist the VOSTF with this proposal and other issues.