

To: Michael Moriarty, Chair of the Valuation of Securities Task Force  
Members of the Valuation of Securities Task Force  
From: Matti Peltonen, New York Insurance Department  
Chris Evangel, Managing Director SVO  
Bob Carcano, Senior Counsel, SVO  
Re: A Joint Proposal to Reconsider and/or Restructure the Valuation and Reporting  
Processes for Insurer Owned Securities  
Date: November 21, 2006

## 1. Introduction

Part Six of the Purposes and Procedures Manual sets out the general procedure by which insurance companies are to determine the fair value of securities they own. For publicly traded securities, the SVO selects the public price reported for the last trading day of the year and adopts that price as the Unit Price, unless there is reason to believe that a different price is more reliable. For private placements, insurance companies provide the SVO with two written price quotes on the letterhead of financial institutions acceptable to the SVO which the SVO uses to determine a Unit Price.<sup>1</sup> If two price quotes are not provided, the SVO applies other methodologies specified in Part Six. Specific valuation procedures are specified for a number of securities including shares of mutual funds, common stock of insurance companies, stock warrants and common stock and preferred stock issued under investment letters or restricted as to transferability.

The underlying logic of the existing process is that all Unit Prices reported by insurance companies are obtained from a regulator approved source.<sup>2</sup> The Unit Price provides a fair value for statutory accounting purposes in those cases where a security must be reported at the lower of specified valuation measures. For life companies, that means bonds with NAIC 6 designation, as well as preferred stocks with NAIC 4, 5, or 6 designations. For property and casualty companies, that means bonds with NAIC designation 3, 4, 5, or 6, and preferred stocks with NAIC 3, 4, 5, or 6 designations. In addition, perpetual preferred stocks with NAIC 1 or 2 designations owned by property and casualty companies are carried at market value. All common stocks are carried at market value.

In addition, annual statement instructions require all insurers to report a fair value for all bonds and preferred stocks regardless of the credit quality. For example, even an insurer entitled to use amortized value in the "Book/Adjusted Carrying Value" column, must use Unit Price in the "Rate Used to Report Fair Value" column. In addition, all insurers are required to report a fair value for all Other Invested Assets.

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<sup>1</sup> Actually, the SVO develops an analytical value for many private placement securities that is maintained on the analyst's screen but the SVO has not determined to enter these values into the VOS Database.

<sup>2</sup> The current system reflects the long held view of the regulatory community to require that the values reported by insurance companies be obtained from the regulatory community and to overcome logistical issues associated with this by hiring an expert to perform the function on their behalf. This was initiated in 1910 and the current Purposes and Procedures Manual continues to provide for a pricing function.

Our experience is that insurance companies do not comply with Part Six. The SVO first considered correcting ambiguities in Part Six and in the Annual Statement Instructions. For example, the Annual Statement Instructions direct insurance companies to use SVO determined valuations *if they exist*, but does not specifically instruct the insurance company to comply with Part Six by filing the security with the SVO, so the SVO can determine the Unit Price. This would only work if the existing process was enforced. Given the importance of valuation to financial solvency monitoring, we considered it prudent to consider whether a different valuation process would provide regulators more reliable and verifiable valuation information. Accordingly, while NY and the SVO understand it would be possible to clarify and enforce the existing regime instead of proposing a new approach, we suggest that it may be more productive to consider an alternative approach, such as the one discussed immediately below.

## **2. Threshold Issue – Utility of Valuation**

NY and SVO staff understand that before proceeding to a consideration of the issue posed above, regulators may wish to consider whether they: 1) need the SVO to determine fair value for investments carried at amortized value or limit valuation for those investments that are reported at lower of amortized or fair value; 2) want the SVO to perform the "bench-mark" test proposed for all or just some investments; 3) use the fair value for financial condition analysis; and 4) think the analysis is of enough significance to require an independent check of all such investments. If the answer to these questions is yes, it would be appropriate to then consider whether the current approach should be enforced or another approach considered.

## **3. A Potential Alternative Valuation Framework**

The proposed alternative valuation method continues the role of the SVO in the valuation of securities. Accordingly, in the case of publicly traded securities, the SVO would publicly identify the vendor(s) it uses and the standard for the price it selects as the Unit Price. For private securities, the SVO would continue to determine analytical values. However, while insurance companies can choose to use SVO determined values, they would also be permitted to determine a value by applying another approved valuation method, provided they identify the method used to the regulator in a new annual statement column. The valuation methods and corresponding codes are as follows:

“1” - the rate determined by the unit price in the NAIC *Valuation of Securities database*.

“2” - the rate is determined by an approved pricing service.

“3” - the rate is determined by a stock exchange.

“4” - the rate is determined by a broker or custodian.

“5” - the rate is determined by the insurer.

In order to counter non-uniformity of valuation on a CUSIP basis, the proposal envisions that the NAIC will develop a mechanism to calculate the averages for insurer reported prices for any CUSIP, so that the regulators can compare this value with the

insurer reported price and the SVO benchmark. The three data bits would be available, side by side, in the VOS database and I-site where they can serve to identify material discrepancies between the filed, average and SVO values. Jumpstart reports can be developed to identify material discrepancies between the reported and SVO determined values. The proposal also envisions that as part of the research function/exam related analysis, the SVO will assist the States in evaluating the pricing methods used by the insurers.

We believe that by providing greater flexibility to insurers, the alternative approach could provide an incentive for greater and more meaningful compliance. Insurers can continue to use SVO determined values, but they can also use other methods – selected and pre-approved by regulators – that may be more reflective of the insurer’s perception of asset value. It is unclear how big a risk of increased non-uniform valuation the Association would run since we assume an undefined level of non-compliance today. In any event, the risk of an increase in non-uniform valuation would be continuously monitored and the regulator provided with benchmarks with which to question insurer management on valuation policy and practice.

#### **4. Anticipated Changes to NAIC Guidance**

Implementation of the proposal would require an amendment to Schedule D to add a column to capture the code corresponding to the valuation method chosen by the insurance company. In addition, an amendment to the Annual Statement Instructions would be necessary. Both the necessary changes to Schedule D and the Annual Statement Instructions are shown in Attachment One. The changes required to Part Six of the Purposes and Procedures Manual is shown in Attachment Two. The proposal also contemplates changes to NAIC systems. In addition, the Task Force should consider whether instructions should be added to the Examination Handbook to ensure that regulators understand the need to question insurers as to the basis of their valuations.