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Growth in Private Ratings Among U.S. Insurer Bond Investments and Credit Rating Differences

Analysts: Jennifer Johnson, Michele Wong, and Linda Phelps

Executive Summary

- The number of privately rated securities reported by U.S. insurance companies totaled 5,580 at year-end 2021, an increase from 4,231 in 2020 and 2,850 in 2019.
- Small credit rating providers (CRPs) to the NAIC, such as Egan-Jones, DBRS Morningstar, and the Kroll Bond Rating Agency LLC (KBRA), produced a dominant share of the private letter ratings (PLRs), accounting for almost 83% of U.S. insurers' privately rated securities as of Dec. 31, 2021.
- Designations based on PLRs averaged 2.375 notches higher than designations assigned by the NAIC Securities Valuation Office (SVO) according to data from 2019 through Q3 2021.
- Based on the credit rating analysis conducted by the SVO, the use of PLRs can result in lower risk-based capital (RBC) charges and potentially lead to the undercapitalization of insurance companies.
- Regulatory oversight of nationally recognized statistical rating organizations (NRSROs) does not result in uniform ratings across the NAIC's CRPs.
- Ten U.S. insurer groups accounted for 55% of the industry's exposure to privately rated securities at year-end 2020.
- No significant issuer concentrations of privately rated securities were noted.

What Are Private Letter Ratings and Privately Rated Securities?

PLRs are private ratings assigned to securities by NAIC CRPs in the form of a letter or report, which can be obtained by an insurer in its capacity as an investor in the rated security through a confidential process established by the CRP. A privately rated security is a security with a credit rating from a CRP, which is communicated to the issuer and a specified group of investors only, and it is not publicly released via the CRP's public data feed or website. Therefore, a privately rated security is the subject of

the PLR. There are currently eight NAIC CRPs, including larger rating agencies such as S&P Global, Moody's Investors Service (Moody's), FitchRatings, as well as smaller credit rating agencies.

PLRs, unlike public ratings, are less transparent to the marketplace, as they are issued confidentially only to the investor group. While rating agency use of PLRs is not new, the NAIC required insurance companies to begin submitting PLRs for verification beginning in 2018. Since then, the SVO's review has essentially been limited to a verification that the letter submitted is for the appropriate security and the current year. However, in response to concerns identified through the verification process and the lack of transparency of PLRs, insurance companies will be required to file full rating rationale reports beginning in 2022.

Rating rationale reports for PLRs, like publicly available reports, should explain the transaction structure, disclose the methodology relied upon, and include an analytical review of the business, financial, industry, and legal risks considered in the analysis of the credit. The submission of rating rationale reports will also provide greater transparency to the SVO in its review of whether a security is eligible for filing exemption (FE) or designation in accordance with the policies and procedures specified in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual).

It is important to note that not all CRP-rated securities are eligible for designation pursuant to the FE process. If a security is deemed to be ineligible for FE, then the insurance company can either file that security and necessary documentation with the SVO for an NAIC designation or self-assign an NAIC 5.B GI Designation to the security and report it in the related General Interrogatory. Other investments may not be eligible for designation even if filed with the SVO.

Significant Growth in Privately Rated Securities at U.S. Insurers

U.S. insurance companies' use of PLRs has increased significantly over the past few years. In 2019, the first year in which the NAIC required PLR filings, insurers reported 2,850 privately rated securities (see Table 1). In 2020, the number of privately rated securities increased significantly by 48% to 4,231 and continued to rise to 5,580 at year-end 2021, an increase of 32% in 2021.

Table 1: Privately Rated Securities Reported by U.S. Insurers, 2019 – 2021*

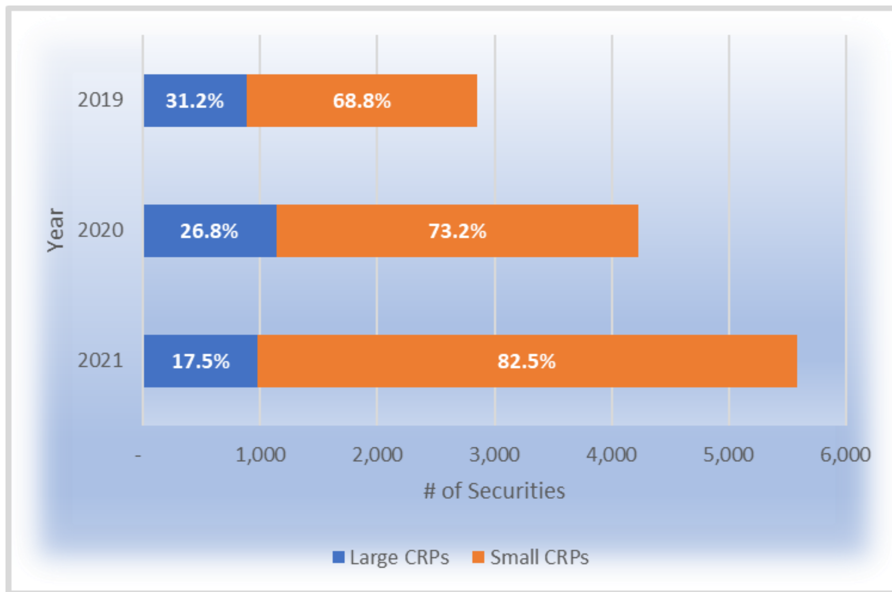
Year	Large CRPs	Small CRPs	Total
2019	888	1,962	2,850
2020	1,134	3,097	4,231
2021	977	4,603	5,580

In terms of book/adjusted carrying value (BACV), at year-end 2020, there was $190 billion in total privately rated securities (as reported in Schedule D Part 1 [Bonds] and Part 2 Section 2 [Preferred Stock]), representing a 39% increase from $136.9 billion at year-end 2019. Privately rated securities represented approximately 4% of total Schedule D Part 1, and Part 2 Section 2 assets, which totaled approximately $4.7 billion, at year-end 2020.

While all CRPs provide PLRs, the small CRPs have been much more active than their larger counterparts. In this analysis, CRPs that have issued PLRs on U.S. insurer investments are categorized based on their market share of the global credit rating industry. Large CRPs include S&P Global, Moody's, and FitchRatings; and small CRPs include AM Best, Egan-Jones, HR Ratings, KBRA, and DBRS Morningstar.

Chart 1 shows the growth in privately rated securities reported by U.S. insurers from 2019 through 2021 and CRPs' share of these securities. Unlike in public credit ratings, small CRPs account for a dominant share of PLRs. As of year-end 2021, small CRPs provided PLRs on 83% of the privately rated securities owned by U.S. insurance companies, an increase from 69% in 2019 and 73% in 2020.

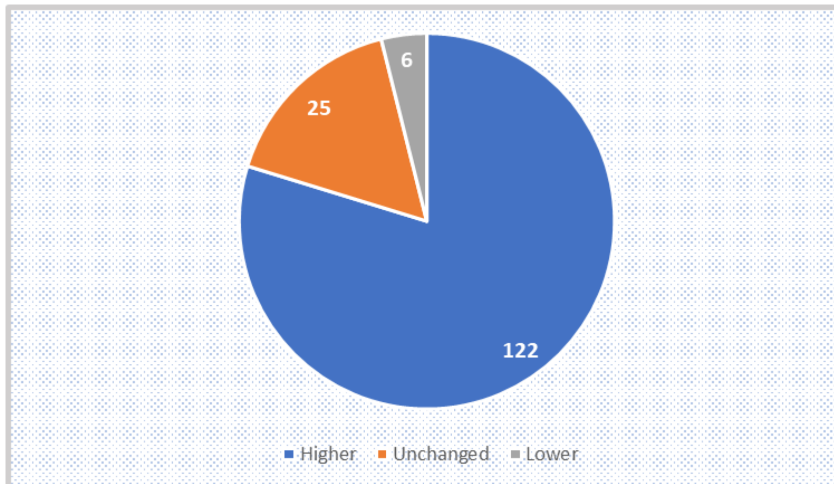
Chart 1: Share of Privately Rated Securities for Large and Small CRPs, 2019 – 2021



Within the small CRP group, Egan-Jones has been the leading provider of PLRs for U.S. insurers, followed by DBRS Morningstar and KBRA. Meanwhile, FitchRatings has been the leader within the large CRP group.

Migration from designations assigned by the SVO to designations based on PLRs is becoming evident with U.S. insurance companies increasingly turning to private ratings, particularly those issued by small CRPs. Between 2020 and Q3 2021, 143 securities moved to a PLR from an SVO designation. The PLRs for the majority of the migrated securities, or 112 securities, were higher than the SVO designation, suggesting the security carried lower credit risk, resulting in a lower RBC requirement (see Chart 2). Small CRPs accounted for 90% of the higher designations, while large CRPs represented only 10%, indicating that the SVO-assigned designations were largely in line with ratings assigned by the large CRPs. On average, designations were 2.375 notches higher, with designations 2.4 notches higher at small CRPs and 1.9 notches higher at large CRPs.

Chart 2: Change in Designations for U.S. Insurer Securities Migrated to PLR Designation, 2020 – 2021*



*As of Sept. 30, 2021.

In addition, 35% of the changes that resulted in a higher designation between 2020 and Q3 2021 experienced a change of 3 or more notches. There were nine instances of a change of 6 or more notches, all where the PLR provider was a small CRP. Furthermore, there were 17 privately rated securities whose designations migrated from an SVO designation mapping to high-yield credit quality to a PLR designation mapping to investment grade credit quality.

U.S. Insurer Concentrations in Privately Rated Securities

The 10 largest U.S. insurer groups with PLR investments, in terms of BACV, at year-end 2020 were represented mostly by large life companies. Altogether, they accounted for $104.1 billion in BACV in PLR investments, which was 55% of total PLR investments at year-end 2020. The top three insurer groups accounted for about 25% (see Table 2).

Table 2: Ten Largest U.S. Insurer Groups with PLRs as a % of Total PLR Investments (BACV$ in billions), Year-End 2020

Insurer Group	$bil BACV	% of Total
Group 1	$16.8	9%
Group 2	$14.8	8%
Group 3	$14.3	8%
Group 4	$10.0	5%
Group 5	$9.1	5%
Group 6	$9.0	5%
Group 7	$8.6	4%
Group 8	$7.8	4%
Group 9	$7.5	4%
Group 10	$6.2	3%
Top 10 Total	**$104.1**	**55%**
Total	**$190.0**	

For the top 10 insurer groups, PLR investments increased by an aggregate $29.3 billion in BACV from 2019 to 2020; the top 10 U.S. insurer groups in 2019 accounted for $74.7 billion. The names of the insurer groups in the top 10 did not change year-over-year (YOY). Additionally, in 2020, total PLR investments were 20.4% of total capital and surplus compared to 15.8% in 2019. While PLR investments as a percent of this surplus value increased YOY, concern is somewhat mitigated by the exposure being concentrated among large life companies; i.e., those with more than $10 billion in assets under management.

The 10 largest issuers with PLRs held by U.S. insurers at year-end 2020 were only 8% of total PLR investments (see Table 3). This was consistent in terms of the percentage to the BACV of the same issuers in 2019. However, the BACV increased by $5.6 billion, or 54%, for the same 10 issuers from 2019 to 2020. Note that the top 10 issuers with PLRs accounted for about half of the total U.S. insurers' PLR investments at year-end 2020.

Table 3: Top 10 Issuers with PLRs for U.S. Insurers (BACV$ in billions), Year-End 2020

Issuer Name	2019	2020	YOY Change
Arthur J. Gallagher & Co.	$0.0	$3.3	-
Varagon Sdlp Senior Note Trust	$1.6	$1.9	19%
Jetro Holdings, Inc.	$1.1	$1.8	63%
Reyes Holdings, L.L.C.	$1.8	$1.7	-5%
Trademark Royalty 2018-1 LLC	$1.3	$1.3	0%
Hofer Financial Services Gmbh	$1.4	$1.3	-8%
SEGRO Plc	$0.9	$1.2	29%
The Irvine Company, LLC	$1.1	$1.1	5%
EDENS Limited Partnership	$0.0	$1.1	-
AES Southland Energy, LLC	$1.1	$1.1	0%
Top 10 Total	**$10.3**	**$15.9**	54%
Top 10 as % of Total	**8%**	**8%**	

Rating Differences Among Credit Rating Providers

The SVO performed an analysis to determine the differences, if any, of credit ratings across NAIC CRPs. The analysis compared the credit ratings of all public and private securities held by U.S. insurance companies in 2020 and through Sept. 30, 2021, rated by more than one CRP. Credit ratings were converted into a numerical equivalent, and the difference between the equivalents reflect how credit ratings vary in terms of rating increments, or "notch differences."

For 2020, the data sample included approximately 625 private ratings and over 1.4 million public ratings. Generally, private ratings provided by large CRPs were, on average, 1.3 notches lower than those provided by their counterparts for the same security, while private ratings provided by small CRPs were 1.2 notches higher (see Table 4). Public ratings, on the other hand, were more comparable across all CRPs, with small CRP ratings only 0.4 notches higher than other ratings for the same security.

Table 4: NAIC CRP Rating Notch Differences, 2020 – 2021*

	Private Ratings		Public Ratings	
Year	Large CRPs	Small CRPs	Large CRPs	Small CRPs
2020	(1.3)	1.2	-	0.4
2021*	(1.2)	1.0	-	0.4

*As of Sept. 30, 2021.
Note: A negative value indicates ratings are lower than comparison ratings, and a positive value indicates ratings are higher than comparison ratings.

Analysis of 2021 private and public ratings revealed similar results through Sept. 30, 2021. Large CRP private ratings were, on average, 1.2 notches lower than those provided by their counterparts for the same security, while small CRP private ratings were 1 notch higher. Similar to 2020, public ratings were more comparable across all CRPs, with lower notch differences. The 2021 data sample included approximately 702 private ratings and over 1.4 million public ratings.

The analysis indicates that notch differences across CRPs were larger for private ratings compared to public ratings, and private ratings provided by small CRPs are generally higher than those provided by large CRPs, in some cases as much as almost 3 notches for a specific CRP. The recent growth in PLRs raises the concern that U.S. insurers with concentrations in privately rated securities may not have adequate capital cushion relative to the actual credit risk in their portfolios.

Regulatory Framework Overseeing Rating Agencies Does Not Result in Uniform Ratings

The Credit Rating Agency Reform Act of 2006 (CRARA) requires rating agencies seeking NRSRO recognition to make their methodology information publicly available to foster accountability, transparency, and competition among the credit ratings industry. The CRARA aims to make the differences between rating agencies and their methodologies visible to enable users of ratings, like insurance companies and the NAIC, to make informed decisions about the strengths and weaknesses of individual rating agencies' methodologies and, thereby, their ratings. However, there is currently no regulatory oversight to monitor or assess the uniformity or quality of credit ratings, nor any uniformity among the rating agencies themselves.

Currently, as a matter of policy, the NAIC and insurance industry must deem any one particular CRP rating as the functional equivalent of any other, regardless of the methodology used or consistency of the ratings assigned. That is, a AAA rating is treated as AAA no matter which CRP assigns the rating. However, as noted above, the NAIC has observed disparities between CRP ratings of the same credit, particularly with PLRs. These rating disparities, some of which are significant, call into question the quality and comparability of PLRs, and they will have an adverse impact on capital requirements under the current RBC framework.

Questions and comments are always welcome. Please contact the Capital Markets Bureau at CapitalMarkets@naic.org.

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