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Earn Continuing Regulatory Education Credits by Reading *The Examiner!*

How Artificial Intelligence is Shaping the Future of Risk Management and What We Can Learn from Baseball Statistics & Analytics (Sabermetrics Approach)

Multiple Choice Questions — Submit Answers Online

1. Sabermetrics
   a. Is used for the study of baseball statistics and analytics
   b. Involves the use of advanced statistics to evaluate player performance and make strategic decisions in the game
   c. a and b
   d. None of above

2. Some of the ways AI can be used in risk management include:
   a. Predictive Analytics
   b. Fraud Detection
   c. Cybersecurity
   d. A replacement for human judgment and expertise

3. Which of the comments are correct?
   a. Parametric risk transfer is a risk transfer mechanism that uses objective, pre-agreed-upon parameters to trigger payouts
   b. AI can facilitate the use of parametric risk transfer
   c. None of the above
   d. All of the above

4. AI can:
   1. enable faster, more accurate risk assessments
   2. improve underwriting processes
   3. enhance claims management
   4. enable insurers to officer new types of insurance products

   a. All of the above
   b. None of the above
   c. 1 and 3
   d. 2 and 3

5. Risks and challenges associated with AI in risk transfer are:
   a. The potential for bias in AI algorithms
   b. The need for highly skilled professionals to develop and implement AI solutions
   c. a and b
   d. b only

A New Banking Crisis

Multiple Choice and True or False Questions — Submit Answers Online

6. Which bank was taken over and sold to J. P. Morgan by the FED?
    a. Signature Bank
    b. First Republic Bank
    c. Silicon Valley Bank
    d. All of the above

7. Which banks failed in March 2023?
    a. First Republic Bank and JP Morgan
    b. First Republic Bank and Silicon Valley Bank
    c. Silicon Valley and Signature Bank
    d. Signature Bank and First Republic Bank

8. Silicon Valley Bank was subject to many of the additional banking stress tests that were put in place in 2018.
    a. True
    b. False

9. 4) Which financial institution was acquired by UBS?
    a. Signature Bank
    b. First Republic Bank
    c. Silicon Valley Bank
    d. Credit Suisse

10. 5) Has Moody's downgraded the credit rating for the banking sector?
    a. Yes - A and B
    b. Yes - A+ - A-
    c. No change to credit rating apart from now has a negative outlook
    d. No change to credit rating or outlook

Captives and Admitted Carriers Working Together

Multiple Choice and True or False Questions — Submit Answers Online

11. Statutory Issue Paper No. 1 discusses why majority owned subsidiaries should not be consolidated stating, "Currently, statutory reporting entities do not consolidate the financial statements of a majority owned subsidiary in their annual statement filing. Investments in majority-owned subsidiaries are reported in Schedule D of the Annual Statement as other investments of a similar type.

    a. True
    b. False

12. Generally Accepted Accounting Principles define a SCA entity as 10% or more of the voting shares of the entity.

    a. True
    b. False

13. Statutory Issue Paper No. 46 describes the carrying value of insurance SCA, "The statutory equity method as described in subparagraph 7.b.i. shall be applied by recording an initial and subsequent investment in an investee at cost, which is defined in SSAP No. 68 as the sum of:

    a. Any cash payment and the fair value of other assets distributed
    b. The fair value of any liabilities assumed
    c. Any direct costs of the acquisition
    d. None of the above
    e. Just s
    f. a, b, & c

14. Risk-Shifting is defined as the possible risk of loss shifting from one person to another person. In Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987) risk-shifting was defined as "transferring from the insured to the insurer of a possible future event."

    a. True
    b. False

15. In the Model law there is a provision that when different state insurance department regulates both the carrier and the captive in a reinsurance arrangement there is not a collateral requirement to avoid the reinsurance recoverable penalties.

    a. True
    b. False

Discussion of IT Reviews Relating to Captives and RRGs

Multiple Choice Questions — Submit Answers Online

16. Which of the following characteristics are not associated with RRG's?
    a. Writes only liability coverage
    b. Must submit a plan of operations to the states
    c. Are housed anywhere in the world
    d. No need for fronting papers

17. Which type of organizations line up with the NAIC Financial Examiners Handbook IT review process?
    a. Are housed in the U.S. only
    b. Stock can be owned by different entities than the insured
    c. Can write all lines of business
    d. Can easily operate across state lines without issue

18. Which type of organizations line up with the NAIC Financial Examiners Handbook IT review process?
    a. A small company that uses spreadsheets or an access database to track the business
    b. A large company that has an internal IT department
    c. A small company that is managed by a third party
    d. A Company located outside of the United States

19. What is the biggest challenge related to an IT portion of a RRG or Captive exam?
    a. Not having CPA workpapers for the IT portion
    b. Company using service providers that are not regulated by an insurance department
    c. Not having a SOC 1, 2, or 3 report
    d. Company using spreadsheets only for tracking claims and premiums

20. Which of the following is not a good IT control?
    a. Disaster Recovery Plan
    b. Breach Response Plan
    c. Server located in an unlocked room
    d. Multiple Factor Authentication access to the network(Server)

PwC NAIC Meeting Newsletter Spring 2023

Multiple Choice and True or False Questions — Submit Answers Online

21. The Innovation, Cybersecurity and Technology Task Force's planned model bulletin for the regulatory framework for use of Artificial Intelligence ("AI") by the insurance industry will be:
    a. Principles based (as opposed to prescriptive)
    b. Rely on external objective standards
    c. Place responsibility on licensees to conduct appropriate diligence of third-party data
    d. All the above

22. The RBC Investment Risk and Evaluation Working Group exposed for comment a proposed C-1 RBC factor of 45% and a sensitivity factor of 10% for residual tranches with the intention to be an interim solution to address concerns of potential RBC arbitrage involving residual tranches in structured assets.
    a. True
    b. False

23. The Valuation of Securities Task Force adopted the controversial "Structured Equity and Funds proposal" which aimed to eliminate preferential RBC treatment compared to if the insurer owned the underlying investment directly.
    a. True
    b. False

24. Which of the following was a Blanks Working Group exposure proposal highlighted in the Spring 2023 NAIC Meeting Notes:
    a. Split Schedule D, Part 1 into two sections for issuer credit obligations and for ABS related to the SAPWF bond project
    b. Add a new financial statement footnote to the Life annual statement to obtain information for the new C-2 RBC mortality risk charges
    c. Add additional instructions to disclose more information on investment income in response to SSAP 34 adopted changes
    d. All the above

25. The Life Actuarial Task Force adopted and exposed updates included an exposure that would reduce reporting lag associated with the VM-50/VM-52 mortality experience data collection process from _____ to _____ beginning in 2025.
    a. One year to six months
    b. Two years to one year
    c. Four years to two years
    d. Five years to three years

How Artificial Intelligence is Shaping the Future of Risk Management and What We Can Learn from Baseball Statistics & Analytics (Sabermetrics

By Dr. Marcus Schmalbach
RYSKEX Inc.

Introduction

What is Sabermetrics?

Sabermetrics is a term used to describe the study of baseball statistics and analytics. It involves the use of advanced statistics to evaluate player performance and make strategic decisions in the game. The term was coined by Bill James, a baseball writer and statistician who published a series of books on the subject in the 1980s and 1990s. Sabermetrics has revolutionized the way baseball is played, scouted, and analyzed. It has provided teams with new insights into the game and has helped them make more informed decisions when it comes to player development, drafting, and roster construction. In this article, we will explore the history of Sabermetrics, its impact on the game of baseball, and some of the most commonly used metrics in the field.

History of Sabermetrics

The use of statistics in baseball dates back to the late 19th century when box scores were first published in newspapers. However, it was not until the 1970s and 1980s that statisticians like Bill James began to develop new metrics to better evaluate player performance. James and other early Sabermetricians used a variety of statistical tools, such as on-base percentage, slugging percentage, and runs created, to measure the value of players and teams. In the 1990s, the use of computers and advanced statistical modeling techniques became more prevalent, leading to even more sophisticated analysis of player performance. Today, most Major League Baseball teams have entire departments devoted to data analysis, and Sabermetrics has become an essential part of the game. Impact on Baseball Sabermetrics has had a significant impact on the way baseball is played, scouted, and analyzed. One of the most significant changes has been the emphasis on on-base percentage and other advanced hitting metrics. Traditionally, batting average was used as the primary measure of hitting performance, but Sabermetricians have shown that on-base percentage is a more accurate predictor of run production and overall offensive value. Another important application of sabermetrics is in player evaluation and development. Teams now use advanced statistical models to identify players with the highest potential for success and to determine the best ways to develop their skills. This has led to a greater emphasis on player development in the minor leagues and a more data-driven approach to scouting and drafting.

There are many different Sabermetric metrics used to evaluate player performance, but some of the most commonly used include:

- On-Base Percentage (OBP): OBP is a measure of how often a player gets on base, either by hit or walk. It is considered a more accurate measure of hitting performance than batting average.

- Slugging Percentage (SLG): SLG measures the power of a hitter by calculating the average number of bases per at-bat.
- Weighted On-Base Average (wOBA): wOBA is a more advanced measure of offensive performance that takes into account the value of each offensive event (e.g., single, double, home run) and adjusts for park and league factors.
- Fielding Independent Pitching (FIP): FIP is a measure of a pitcher's performance that takes into account only the factors that the pitcher can control, such as strikeouts, walks, and home runs allowed.
- Wins Above Replacement (WAR): WAR is a comprehensive measure of a player's value that takes into account their offensive and defensive contributions, as well as their position and the quality of their competition.

Interim Conclusion on Sabermetrics and its impact on Baseball

Sabermetrics has become an essential part of the game of baseball, providing teams with new insights into player performance and helping them make more informed decisions about player development, scouting, and roster construction. The use of advanced statistical models and data analysis has revolutionized the game and has led to a greater emphasis on player development and a more data-driven approach to decision-making. Technology has evolved significantly since the origins of Sabermetrics, and artificial intelligence or sub-forms of it offer entirely new possibilities. In the next section, we will show how Artificial Intelligence or which forms of it are used in the field of Sabermetrics and what the resulting added values are

Sabermetrics and Artificial Intelligence

Sabermetrics is the practice of using statistical analysis to understand and evaluate baseball players and teams. Artificial intelligence (AI) is a field of computer science focused on creating intelligent machines that can perform tasks that typically require human intelligence, such as perception, learning, reasoning, and decision-making. Sabermetrics and AI are linked in several ways. Sabermetrics relies heavily on the use of data and statistical models to gain insights into player performance and team strategy. AI can be used to analyze this data more efficiently and accurately than traditional statistical methods. For example, machine learning algorithms can identify patterns in player performance data that might be difficult for a human analyst to spot. Additionally, AI can be used to create predictive models that can help teams make better decisions. For example, AI algorithms can analyze player performance data, scouting reports, and other relevant information to predict how a player might perform in the future. This information can be used to make informed decisions about player acquisitions, lineup changes, and other strategic decisions. Overall, the combination of Sabermetrics and AI has the potential to revolutionize the way baseball is played and managed, providing teams with new tools to gain a competitive advantage. Some readers will now think - great! The author seems to have a lot of fun with baseball, but where is the transfer to risk management or the transfer of complex risks? Patience, at the end there will be a big picture - promised. Let's add another piece of the puzzle in the next section - the use of Artificial Intelligence in Risk Management.

Artificial Intelligence in Risk Management

Artificial intelligence (AI) has become an increasingly important tool in risk management, allowing businesses and organizations to identify, assess, and mitigate risks more effectively. Some of the ways AI can be used in risk management include:

Predictive Analytics: AI can analyze large volumes of data from multiple sources, such as financial data, customer behavior, and market trends, to identify potential risks and predict future outcomes. This can help businesses make more informed decisions and take proactive measures to mitigate risks.

Fraud Detection: AI can help detect fraudulent activities, such as credit card fraud or money laundering, by analyzing transaction data and identifying patterns or anomalies that may indicate fraudulent behavior. This can help prevent financial losses and maintain the integrity of financial systems.

Cybersecurity: AI can be used to detect and prevent cyber threats, such as malware or phishing attacks, by analyzing network traffic and identifying suspicious activity. This can help protect sensitive data and prevent cyber attacks.

Compliance Monitoring: AI can help ensure compliance with regulations and policies by monitoring transactions and activities for potential violations. This can help reduce the risk of fines and penalties for non-compliance.

Natural Language Processing: AI can analyze text data, such as emails or social media posts, to identify potential risks, such as reputational damage or customer dissatisfaction. This can help businesses respond to potential risks in a timely manner and take appropriate action.

Overall, AI can provide businesses with a more comprehensive and accurate view of potential risks, allowing them to make more informed decisions and take proactive measures to mitigate risks. However, it's important to note that AI is not a replacement for human judgment and expertise, and should be used in conjunction with other risk management strategies.

Interim conclusion on Sabermetrics, AI & Risk Management and what they have in common

Sabermetrics, artificial intelligence (AI), and corporate risk management are all related in that they involve the use of data analysis and modeling techniques to make informed decisions.

Sabermetrics is the empirical analysis of baseball data, with the goal of identifying and quantifying the most important factors that contribute to a team's success. Sabermetrics makes use of statistical models to help evaluate players, teams, and strategies. This approach has since been applied to other sports as well. Artificial intelligence refers to the use of computer algorithms and machine learning to analyze data and make predictions or decisions. AI can be used to develop more sophisticated models for evaluating performance, predicting outcomes, and identifying risks. Corporate risk management involves identifying, analyzing, and prioritizing risks that a company may face, and taking steps to mitigate those risks. This can involve the use of data analysis and modeling techniques to identify potential risks and predict their likelihood and impact. The link between Sabermetrics, AI, and corporate risk management is that they all involve the use of data analysis and modeling to inform decision-making. In each case, the goal is to use data to make more informed decisions and to identify and mitigate risks. Sabermetrics and AI can be seen as specific applications of data analysis and modeling techniques, while corporate risk management is a broader concept that can incorporate these techniques as well. The fog is lifting. So corporate risk management can certainly draw inspiration from baseball and its approach. One of the most important tasks of risk management is the transfer of risks. In the next section, the author discusses whether there is a logical connection between artificial intelligence and parametric risk transfer.

How AI impacts the corporate risk management and offers the opportunity for Parametric Risk Transfer (PRT)

Artificial intelligence (AI) has emerged as a game-changer in various fields, and one such area is corporate risk management. Companies are increasingly turning to AI for managing risks more efficiently and effectively, and this has led to the emergence of a new approach to risk transfer - parametric risk transfer. Parametric risk transfer is a risk transfer mechanism that uses objective, pre-agreed-upon parameters, such as weather conditions or seismic activity, to trigger payouts. This approach is gaining popularity as it allows for faster claims processing and settlement, eliminates the need for complex loss assessments, and reduces administrative costs. AI can facilitate the use of parametric risk transfer by enabling companies to collect and analyze large amounts of data to identify risks and develop appropriate parameters for triggering payouts. For instance, a company may use AI to analyze weather data and identify specific temperature, wind, or rainfall thresholds that trigger payouts for property damage or business interruption losses. In addition to enabling more efficient risk transfer, AI can also help companies manage risks more effectively by providing real-time data and insights. By using AI to analyze market trends, customer behavior, and other relevant data, companies can better anticipate and respond to risks, reducing the likelihood of losses. AI can also be used to automate risk management processes, such as claims processing and underwriting, which can improve efficiency and accuracy.

For example, an insurance company may use AI-powered chatbots to handle customer claims and inquiries, reducing the need for manual intervention and improving response times. Furthermore, AI can help companies identify and mitigate emerging risks that traditional risk management methods may not identify. By analyzing large volumes of data from multiple sources, AI can identify patterns and trends that indicate new risks, enabling companies to take proactive measures to prevent losses. However, as with any technology, AI also presents certain risks and challenges. One of the main challenges is the need for highly skilled professionals to develop and implement AI solutions. Additionally, AI algorithms are only as good as the data they are trained on, so ensuring the quality and accuracy of data is critical. Another challenge is the potential for biases in AI algorithms, which can lead to unfair or inaccurate decisions. Companies must take steps to ensure that their AI solutions are designed and tested to be fair, transparent, and free from bias. In conclusion, AI has the potential to transform risk management and offers the opportunity for parametric risk transfer. By enabling companies to collect and analyze large amounts of data, automate processes, and identify emerging risks, AI can help companies manage risks more efficiently and effectively. However, companies must also be aware of the potential risks and challenges associated with AI and take steps to ensure that their AI solutions are designed and implemented responsibly. Furthermore, the current AI hype is so high that people are expecting too much from the technology and forget that artificial intelligence works in a similar way to human intelligence - by learning. You have to train the machine and feed it with the right data. This should be done by experts and will take time. Often I have seen solutions on the market that like to boast with the addition of AI, but it is only a data storage / information system. Not everywhere where AI is on it is also AI in it. Analog humans - not all have the same IQ... Nonetheless, AI and parametric solutions will shape the future of corporate risk management and risk transfer, respectively, so the last section is a look into the future.

How AI shapes the risk transfer concepts of the future

The future of risk transfer is likely to be heavily influenced by artificial intelligence (AI), which has already started to revolutionize the insurance industry. AI has the potential to transform risk transfer by enabling faster and more accurate risk assessments, improving underwriting processes, and enhancing claims management. One of the most significant impacts of AI on risk transfer will be in the area of predictive analytics. AI algorithms can analyze vast amounts of data from multiple sources, including social media, news, and weather reports, to identify patterns and trends that may indicate new risks or emerging threats. By using this data, insurance companies can develop more accurate risk models and make better-informed decisions about pricing and underwriting. AI can also help insurers to automate many of their risk management processes, reducing the need for human intervention and improving efficiency. For example, chatbots and virtual assistants can handle customer claims and inquiries, reducing the workload on customer service teams. Claims can be processed faster, and policyholders can receive payouts more quickly, reducing the impact of losses on their businesses. Furthermore, AI can help insurers to develop more personalized products and services. By analyzing data about individual customers, AI algorithms can identify specific risks that may affect them and offer tailored insurance policies that provide the necessary coverage. This could lead to a shift away from traditional, one-size-fits-all insurance policies towards more bespoke products. Another significant impact of AI on risk transfer is the emergence of parametric insurance products. Parametric insurance uses objective, pre-agreed-upon parameters, such as temperature, rainfall, or wind speed, to trigger payouts. This approach can be used to cover risks that are difficult to assess, such as business interruption losses, and can result in faster claims processing and settlement. AI can enable the use of parametric insurance by enabling companies to collect and analyze large amounts of data to identify appropriate parameters for triggering payouts. For example, a company may use AI to analyze weather data and identify specific temperature thresholds that trigger payouts for property damage or business interruption losses. However, as with any new technology, there are also risks and challenges associated with AI in risk transfer. One of the main risks is the potential for bias in AI algorithms, which can lead to unfair or inaccurate decisions. Companies must take steps to ensure that their AI solutions are designed and tested to be fair, transparent, and free from bias. Another challenge is the need for highly skilled professionals to develop and implement AI solutions. Insurers must invest in training and development to ensure that they have the necessary expertise to leverage the full potential of AI. In conclusion, AI is set to shape the future of risk transfer by enabling faster, more accurate risk assessments, improving underwriting processes, and enhancing claims management. It will also enable insurers to develop more personalized products and services and to offer new types of insurance products, such as parametric insurance. However, companies must also be aware of the potential risks and challenges associated with AI and take steps to mitigate them.

About the Author

Dr. Marcus Schmalbach is Founder and CEO of RYSKEX Inc., based in New York City. He has a long-standing experience in risk and captive management in various industries. Before the founding of RYSKEX he was Head of German MBA program. He is still working as a visiting professor on Risk and Finance matters, and academic head of BlockART Institute with a research focus on Parametric Risk Transfer. He is Professor at ESCP Business School, Paris, France with a research and lecturing focus on Blockchain Technology and Artificial Intelligence.

Market Briefing
A New Banking Crisis?

By Ed Toy | Risk & Regulatory Consulting, LLC, Reprint

Introduction
On Monday, May 1st, prior to the opening of the market, the Fed announced the takeover of First Republic Bank and sale to J.P. Morgan. This was the third major bank failure in the last two months. Market participants continue to focus on other mid-sized banks with similar profiles. Following a spike in March, market volatility had calmed somewhat, allowing some time to reflect on the news and consider the causes or underlying issues as well as what the longer-term impact may be on the economy, investment markets and U.S. insurer investment portfolios. There has also been new information about the extent of the problems at some institutions. At this point, very little is certain, analysis by Governmental agencies and market participants will continue and the landscape of what we know is likely to change.
The Events and Announcements in March
First Republic was similar in that it also had a deposit base that was largely not covered by FDIC insurance. Information about withdrawals in March led to a downgrade by rating agencies to a single B level. On April 24th, First Republic revealed that withdrawals had reached over $100 billion (out of a $200 billion deposit base) before receiving the $30 billion in deposits from other banks as a bailout. First Republic has also indicated that it is facing a $5 billion shortfall in the fair market value of its bonds versus carrying value and a $20 billion shortfall in its mortgage loan portfolio. First Republic continued to look for additional assistance including a possible acquisition as its stock price dropped from a high of $145 a share in February to $3 a share by April 28th, precipitating the most recent action. The problems of these institutions led Moody's to put the entire banking sector on negative outlook on March 14th. These events led common stock of all regional banks to drop. An index of regional bank stocks declined from $65 to $40 and continues to remain in that range. The situation at Credit Suisse appeared to be unconnected to the situation described above. Credit Suisse announced in early March that it had found material weaknesses in its risk management. With that announcement, its stock price dropped by more than half within days. This ultimately led to the announcement on March 19th that Credit Suisse would be acquired by UBS for less than half of the value of where its stock closed the prior business day, even after an injection of more than $50 billion from the Swiss central bank. The acquisition agreement included additional support of more than $120 billion. In addition, Swiss regulators decided to trigger a provision that eliminated $17 billion in Tier One capital securities. Tier One capital securities, and similar types of securities issued by financial institutions, are considered debt instruments but include a provision allowing regulators to either convert them into equity or eliminate them when financial solvency is a concern. Information that has been more recently disclosed is that Credit Suisse saw withdrawals of more than $120 billion in the fourth quarter of 2022 and another $60 billion in the first quarter of 2023.

What are the underlying issues?
While analysis of the various failures and what lead to the current situation is ongoing and there may be additional revelations to come, there are a few basic drivers that are apparent with some regional banks, and perhaps also some larger ones. The liabilities of the many of these financial institutions have proven to be very liquid, not just technically as demand deposits, but also subject to additional factors related to customer behaviors. The fact that the deposits exceeded the $250,000 limit for some of the troubled entities for FDIC guarantees has been noted. Another factor is the increased ability for depositors to move their cash quickly through improved technology. The rise in interest rates in 2022 led to a significant decline in asset values, especially for longer duration investments. Investments that were considered "safe" from any concerns about credit risk were none-theless subject to interest rate risk. These assets were also the more liquid in the portfolio and their sales resulted in significant realized losses. There was significant mismatch between the highly liquid liabilities at the three regional banks that have failed and the longer duration assets that declined significantly in fair market value. The combination of highly liquid liabilities and significant duration mismatch with longer-term assets in a rising interest rate environment did not appear to be properly monitored or managed at the institutions.
Can this happen at an insurance company?

An important question that U.S. insurance regulators have been asking since at least March is: Can this happen at an insurance company? The answer is yes, though based on the the typical structure of liabilities of insurance companies, it is less likely. To the extent that there is risk, it is mainly at Life insurers, though P&C and Health insurers are not immune. Life insurers have seen significant asset growth in recent years, much of that in more liquid, shorter term annuity products, some with more limited surrender penalties. On the asset side of the balance sheet, up through 2021, insurers were able to argue that they had good liquidity in their invested assets. But that analysis relied in part on the fact that fair market values exceeded carrying values, so there was no penalty to sell. Based on anecdotal data for year-end 2022, looking at just a few companies, the relationship has now flipped because of the significant increase in interest rates in 2022. In many cases, the aggregate fair market values are now less than carrying values. While those invested assets may still be liquid, selling would now result in a realized loss and a hit to surplus. The profiles of asset liquidity for insurers have also shifted downward for other reasons. In what had been a prolonged low interest rate environment, there was a gradual shift away from the most liquid Government Bonds to more complex Structured Securities, less liquid assets such as Mortgage Loans, and illiquid assets such as some reported on Schedule BA. This shift has resulted in a portfolio that is significantly less liquid than it may have been a few years ago. Rising rates also introduces additional disintermediation risk, where policyholders of interest-sensitive contracts may leave to get a higher return elsewhere, either through surrenders or by allowing existing policies to mature and not rolling over into a new policy. There may be also another factor that layers on top of the invested assets themselves. That is, there has been a material increase in assets pledged as collateral in recent years. This increase likely resulted for two reasons. First, Life insurers have increased their borrowings from the Federal Home Loan Banks (“FHLBs”) over the years. Borrowings from FHLBs are required to be collateralized. As the fair market values of pledged assets declined, insurers needed to pledge additional assets. Second, the shifting of interest rates, including the inversion of the Treasury yield curve in 2022, also impacted valuations of interest rate derivatives that insurers used as interest rate hedges. This shift led valuations to change, further requiring changes in collateral requirements.
What should regulators focus on?

As this situation continues to evolve, what should insurance regulators be focusing on? What questions should they be asking of their regulated entities?

Some questions are obvious: Do the insurers have deposits in any of the regional banks? Are there holdings of Bonds or Common Stock in regional banks? Expanding beyond that, what is the exposure to Financial Institutions in general? The sector is likely to remain under some pressure, at least as far as earnings are concerned for a while. This will impact stock prices as well credit spreads which will put negative pressure on the value of bonds.

There are also broader questions that relate to the same drivers that impacted SVB, Signature and First Republic. How liquid are the insurer's liabilities? What is the current fair market value versus the carrying value relationship of the portfolio? How well matched are the asset and liability cash flows? How much business is subject to disintermediation risk? Is there a well-documented liquidity policy and how robust is the liquidity stress testing? Does the company have access to contingent liquidity sources?

With the changes in the investment portfolios that have occurred through the low interest rate environment, how well suited are they to the new, higher interest rate environment? One specific example is investments in RMBS. While there may be limited credit risk for these investments, they are highly susceptible to prepayment volatility. As interest rates rise or just stay at levels that are higher than when they were originated, prepayment cash flows will slow. Reports from different asset managers and analysts have indicated that prepayment cash flows are down 50% to 75% since 2021. There are concerns that some additional declines are likely. Another example is investments in Private Funds and Collateral Loans that are reported on Schedule BA. Higher interest rates will have impacted the valuations for Private Funds and likely also the value of assets that support Collateral Loans.

There are also areas for possible, if not likely, contagion risk from weakness in the banking sector, especially regional banks. Regional banks have been the majority lender to commercial real estate. As banks become more conservative in the near term, this is going to impact available funding, at the same time that commercial real estate valuations have softened significantly, vacancy rates are rising, and existing mortgage loans are maturing. Some analyst estimates put the dollar amount of maturing mortgage loans as high as $2 trillion in the next 18 months.

The report of the recent analysis done by banking regulators to assess the causes of failures at SVB and Signature indicated significant failures in risk management. What is the state of risk management tools at insurers and have adjustments been made for the new market environment? What is the sophistication and experience of management concerning investment risk matters? What is the Chief Risk Officer's reaction to current events? What kind of liquidity stress testing do the insurers do? What were the cash flow testing and/or Own Risk and Solvency Assessment ("ORSA") results in rising rate/rate spike scenarios? What kinds of interest rate scenarios are being used as assumptions?

Insurers have typically been able to show that they can manage base case and moderately adverse scenarios cash demands from liabilities with cash flows, possibly relying on selling only the most liquid assets. How reliant is the Company on external sources of capital such borrowing to fund operating shortfalls? Are there restrictions on their ability to borrow?

Closing Thoughts
The failure of SVB, Signature, First Republic and Credit Suisse are significant events. Those three bank failures on their own, based on assets under management, are equivalent to all of the bank failures that occurred in 2008. While there appears to have been specific circumstances at those particular institutions, analysis is ongoing on how extensive the underlying issues may be across the entire Financial sector. There are also significant implications for markets and the economy in general. It is too early to say we have seen all of the problems that may be out there. The various failures and problems in general also need to be considered in the broader context of current markets and the economy. Inflation is declining but still remains high. The Consumer Price Index for March came in at 5.0% for the overall level and 5.6% for the core level. Both of these are still higher than the Federal Reserve's target of 2%. As a result, the Fed may continue to raise its target range for the Fed Funds rate. Equity and Bond markets, even before recent events, had reached higher levels of volatility. With investors on edge, negative news will cause that volatility to spike.

About the Author

Edward Toy is a Senior Manager at Risk & Regulatory Consulting, LLC who performs investment and risk management consulting services for state insurance departments. He has extensive knowledge of insurer investments and investment strategies, and how they fit within regulatory guidance. Ed's professional experience in investments includes 25 years as an analyst, trader, and portfolio manager across multiple asset classes and investment strategies. Prior to his employment with RRC, he served as Senior Technical Policy Advisor, Capital Markets & Macro Prudential Surveillance at the NAIC. His responsibilities included working with state insurance regulators in the development of tools for oversight of the insurance industry as they relate to investment portfolios and coordinating with other NAIC staff and state insurance regulators on matters impacting financial/solvency regulation of insurers and capital markets. While at the NAIC, Ed also founded and served as Director of, the Capital Markets Bureau.

Captives and Admitted Carriers Working Together

By Leon Rives

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Admitted Carriers and Captives; Let's Explore Business Reasons, and some Accounting and Tax Considerations

Bill Murray's character Dr. Peter Venkman proclaimed in the movie Ghostbusters "Cats and Dogs Living Together Mass Hysteria!" However, it is now a norm for admitted carriers and captives to be working together!

Captive usage by traditional carriers is increasing even outside the life insurance world, where that has been significant usage of XXX and VXXX, in Life Carriers, more and more Traditional Carriers along many lines of business. Smart carriers have deployed captive structures whereby there is more risk sharing with the insureds or sponsors of insureds, ex. Employee Benefits, Medical Stop Loss, Workers Compensation...

First let's get nerdy. We will discuss how captives are carried on the Statutory Books of Admitted Carriers, compare and contrast, accounting treatments between Statements on Statutory Accounting Principles (SSAP) and Generally Accepted Accounting Principles (GAAP), move to a bit of tax, then finish up discussing the business opportunities, and why admitted carriers are utilizing captive strategies.

How do captives look on the books of an admitted carrier?
SSAP No. 3 and No. 97 provide authoritative guidance on majority owned entities while Statutory Issue Paper No. 1 discusses why majority owned subsidiaries should not be consolidated stating:

> "Currently, statutory reporting entities do not consolidate the financial statements of a majority owned subsidiary in their annual statement filing. Investments in majority-owned subsidiaries are reported in Schedule D of the Annual Statement as other investments of a similar type (e.g., common stock and preferred stock) and are valued in accordance with the procedures outlined in the Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO Purposes and Procedures). Current GAAP guidance is not consistent with this position and requires consolidation of majority-owned subsidiaries….
>
> The policy of not consolidating majority owned subsidiaries for individual entity statutory reporting is consistent with the recognition concept included in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts), therefore formal codification of such practice is recommended. The current statutory practice for recording the investment in majority owned subsidiaries is also an accepted statutory accounting practice by all states."

For STAT purposes investments in subsidiaries and controlled and affiliated (SCA) entities can use an equity method based on reporting the ownership of the entity using the equity in the SCA's audited financial statements under

GAAP with some adjustments based on the type of entity to Statutory Equity. The difference in the equity from year to year is recorded as an unrealized gain/loss through surplus. Dividends received would be a component of investment income. Statutory Accounting Principles define a SCA entity is 10% or more of the voting shares of the entity.

Blah, Blah, Blah, what this really means is that the investment in a majority owned entity is carried at a value on Schedule D, now what is the value it should be carried?

Statutory Issue Paper No. 46 gives us this information (whether the Statutory Issue Paper No. 46 numbering was correlated to what was originally Fin 46 regarding variable interest entities is either an awesome consequence or a cool joke), as well as Statutory Issue Paper No. 48 which governs Investments in Joint Ventures, Partnerships, and Limited Liability Companies.

There are three methods of valuation in these types of subsidiaries, entities etc. The Market Valuation Approach, The Statutory Equity Approach, (insurance SCAs), and the GAAP Equity Approach (typical captives). Non insurance SCAs which only hold assets can have GAAP equity.

There are many differences between Statutory Accounting Principles (STAT) and Generally Accepted Accounting Principles (GAAP), some examples are Deferred Acquisitions Costs are capitalized and amortized over the life of the policy in GAAP but expensed immediately in STAT, there may be accounts receivable which by rule are non-admitted under STAT but are assets under GAAP, reserves especially for Life and Health companies use specified mortality and morbidity tables and estimates of future investment earnings, lapses, and expenses based on state laws, while GAAP is based on company and industry experience, in addition STAT reserves do not consider withdrawal assumptions where GAAP does, therefore generally STAT reserves are higher than GAAP reserves. GAAP does not have Asset Valuation Reserve or Interest Maintenance Reserve concepts as STAT does, which adds to higher stockholders' equity.

So generally speaking, the GAAP equity will be higher than STAT equity. and since we know that we may be able to carry the captive on the balance sheet of the carrier on a GAAP basis there can be a STAT to GAAP pickup, so long as there is proper risk transfer.

There is one primary area where STAT is more aggressive than GAAP and it relates to retroactive reinsurance contracts. GAAP does not allow the immediate gain unless the ceding company's liability to its policyholders is completely extinguished se ASC 944-605-35-9. Under STAT retroactive reinsurance does not require recoverables to be discounted so many times an immediate increase to surplus is recognized. Although a potential Schedule F or Schedule S penalty would need to be planned around.

Statutory Issue Paper No. 46 describes the carrying value of insurance SCA quoting:

"The statutory equity method as described in subparagraph 7.b.i. shall be applied by recording an initial and subsequent investment in an investee at cost, which is defined in SSAP No. 68 as the sum of (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. After the date of acquisition, the investment amount shall be adjusted for the amortization of goodwill and the reporting entity's share of the change in special surplus funds, other than special surplus funds and unassigned funds (surplus), as defined in SSAP No. 72—Surplus and Quasi-Reorganizations. This represents the carrying amount of the investment."

In order to qualify for accounting and tax purposes risk transfer must occur. Risk transfer is a concept within GAAP, STAT, and Tax. So, let's get to taxes.

Internal Revenue Code Section 816(a) provides that an "insurance company" is any company for which more than one-half of its business is from the "issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies."

To date, neither the Internal Revenue Code nor the Treasury Regulations have defined "insurance" or "insurance contracts." There is, however, extensive case law and administrative rulings by the IRS which provide guidance as to what constitutes "insurance" for Federal tax purposes. The Supreme Court addressed what constitutes "insurance" in Helvering v. LeGierse, stating that "Historically and commonly insurance involves risk-shifting and risk distribution."

As the language quoted above from Section 816(a) makes clear, it is intended that the same principles apply to reinsurance as to insurance. The IRS confirmed this in Revenue Ruling 2002-89 when it analyzed the consequences of insuring "either directly or as a reinsurer."

The two elements, "risk shifting" and "risk distribution," have been a major source of conflict between the IRS and taxpayers for years. These are not the only considerations in determining the presence of "insurance" for Federal income tax purposes. The Tax Courts have expanded the test to include: (1) whether the transaction includes an "insurance risk" and (2) whether the arrangement constitutes "insurance" in its commonly accepted sense.

Risk Shifting is defined as the possible risk of loss shifting from one person to another person. In Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987) risk shifting was defined as "transferring from the insured to the insurer of a possible future event." While this sounds simple it can be complex.

Historically the IRS desired an "economic family" approach to risk shifting, so if the risk of loss was within the same economic family, no risk shifting occurred. In Revenue Ruling 77-316 there are three example situations where risk was transferred from a brother-sister company, a subsidiary, and parent, within the same economic family did not constitute risk shifting.

The court has overturned IRS in Humana Inc. v. Commissioner. The Sixth Circuit rejected the economic family argument. The Court found that risk can be shifted from an insured subsidiary to a brother-sister insurance company subsidiary. The IRS no longer challenges these types of arrangements.

Generally, Risk Transfer from Reinsurance Contracts is the primary concern since in Revenue Ruling 2009-26 presented two situations which illustrate that a reinsurance arrangement is sufficient for the assuming company to qualify as an insurance company under IRS Code Section 831(c) where the you essentially peer through the reinsurance contract to examine the underlying policies issued by the cedant for purposes of testing risk distribution, consistent with the language in Code Section 816(a).

What are some examples of business reasons for utilizing a captive structure?
There are many business reasons for utilizing a captive structure, we will only touch on a few, one of which is an Agency Captive.

In this scenario the carrier and the agent desire to align interests. So, the Agent has some level of ownership of the Agency captive, perhaps the carrier has an interest or not. In this instance a reinsurance contract is executed between the carrier and the agency captive, to cover some tranche of risk, therefore the agent makes money when the risk portfolio performs well.

This is different from traditional profit-sharing commission structures. The primary difference is that in an Agency captive the Agent will have some capital put up, can be done in the form of a letter of credit, therefore the agent has risk of loss. This incentive to place good risk with the carrier which is reinsuring to the captive.

One planning area for carriers is to plan around any Schedule F or Schedule S penalty when utilizing this type of structure as most Agency captives will be unauthorized reinsurers. In the Model law there is a provision that when the same state insurance department regulates both the carrier and the captive in a reinsurance arrangement there is not a collateral requirement to avoid the reinsurance recoverable penalties. So, if this type of structure makes sense, then you would want to ensure your captive's domicile is the same domicile as the carrier to avoid collateral requirements.

These types of Agency captives are growing at a rapid pace and can be beneficial for both the carrier and the agent.

Carrier may simply play the STAT to GAAP pickup game as they transfer risks and premiums into a captive arrangement so assuming that Risk Transfer is achieved on a STAT and GAAP basis.

More and more insured who have grown their balance sheet are willing to take on some risk that have been traditionally moved over to admitted carriers, by an insurance carrier creating a structure to allow for this level of "self-insuring" by the insured utilizing a captive structure there may be better retention of the client.

There may be regulatory reasons, for instance a liability carrier which is only licensed in a few states may form a Risk Retention Group. Risk Retention Groups are in place as a result of the Liability and Risk Retention Act (LRRA). They are only allowed to write liability coverages, excluding workers' compensation.

A benefit of Risk Retention groups is that they can inform each state they will be writing business in that state, contrasted with admitted carrier who must apply for admission to write business in that state. Therefore, a liability carrier may have a quicker entrance to market by forming its own Risk Retention Group.

There is lots of nerdy technical jargon, but overall captive strategies have a great deal to offer, insureds, agents, carriers, and others.

About the Author

Leon L. Rives II is the Chief Visionary Officer in the firm. Leon co-founded the firm and is an investor in several different businesses. Leon has authored more than 20 courses on insurance, insurance accounting, and governmental accounting. Leon is a regular speaker at board meetings and brings his 20 years of experience combined with the ability to communicate complex matters in an easy to understand practical approach. Leon has also assisted in drafting legislative changes in multiple states, regularly comments on proposed legislation affecting insurance companies. He spends most of his time consulting with the C-Suite at insurance companies on various topics ranging from Statutory Accounting, GAAP, and Tax Accounting.

His experience ranges from working with multi-billion dollars insurance carriers to small startup insurance companies.

Involvement

- Former Chair of the North Carolina Mutual Insurance Association
- Former Chair of the North Carolina Captive Insurance Association
- Past Board Member American Red Cross
- Past Treasurer of Sapona Country Club
- Soccer, Basketball, and Football Coach
- Crisis Ministry volunteer
- Former Speaking Faculty Member at the National Association of Mutual Insurance Companies
- Regular Speaker at National Insurance Conferences

Discussion of IT Reviews relating to Captives and RRGs

By Jenny Jeffers
AES, CISA, CFE (Fraud)
Jennan Enterprises, LLC

For many years, financial exams of Captives and RRGs did not include IT exams. Perhaps, the EIC asked some questions or developed a questionnaire. That is because most Captives and RRGs are run by a Captive Manager, and do not provide any IT services themselves. I have held several discussions with regulators relating to this process and suggested that perhaps the best solution is to have the Captive Managers undergo examinations, the results of which could be shared among states and utilized in the examination of the Captive/RRGs that utilize each of the managers. I am not sure what this would involve, as I believe the state may need the authority to perform these examinations.

Currently, we are seeing an increase in the utilization of IT Specialists in the examination of Captives and RRGs. When we started performing this work, I determined that we need to know more about the formations of these companies. What is the difference in a Captive and an RRG? I am sure all of you who are financial examiners are well versed in this, but for my fellow IT Specialists, I will try to summarize quickly.

RRGs

- RRGs are only housed in the U.S.
- You do not need fronting paper for RRGs
- The insured must own stock when it comes to RRGs
- RRGs must submit a plan of operation to the state
- RRGs write liability coverage only
- RRGs can be formed under traditional laws or the state's captive law

Captives

- Captives can be located anywhere in the world
- Fronting paper is used in some captive formations to exist on an established insurance company's (Travelers, AIG, etc.) financial rating and filings across the US and internationally.
- Stock in a captive can be owned by different entities than the insured.
- In the captive model, because the structure is fronted by an A-rated insurer, the captive can operate across state lines with no financial reporting requirements besides to the fronting carrier.
- Captives can write any line of business

Both provide opportunities to provide a solution for self-funded insurance.

When an IT Exam is included in the financial examination of an RRG or a Captive, the organization of the company should be determined. In most cases the IT functionality is delegated to either a Captive Manager or another Information Technology Service Provider (there are some large RRGs that do have their own IT department). Often the actual Captive or RRG has no employees. Some RRGs have employees who track all of their business on spreadsheets and store the spreadsheets on local desktop computers or a single server in the office.

Each of these situations will be discussed below.

In each case, there is information that is entrusted to or owned by the company and it is the responsibility of the IT Specialist on the exam to review the controls around that information.

Case Number 1: Large company with internal IT services

For the large company with an internal IT function, the exam may follow the traditional examination process as outlined in the NAIC Financial Examiners Handbook. These companies may even have CPA workpapers that can be used for reliance to improve the efficiency of the exam.

Case Number 2: Smaller company that has few or no employees and is managed by third parties

For the company with few or no employees and being managed by Service Providers (including a Captive Manager), the process defined in the NAIC Financial Examiners Handbook will need to be performed with customization and scaled to fit the company being examined. Often (usually) there are no CPA workpapers for IT General Controls. No reliance is placed on IT General Controls and the CPAs will simply do substantive testing.

The IT Specialist will need to discover and evaluate the overall governance of the IT processing and establish communications with each service provider to assess:

Verify accurate processing of information utilized for regulatory reporting. This will include evaluating Change Management of systems (including spreadsheets) utilized for this purpose. How changes are tracked, tested and implemented should be reviewed and evaluated. This control will need to be assessed for all service providers who process information for the company.

Review user access to systems utilized for processing the business of the company to ensure it is limited. This may involve more than one service provider as often the Captive Manager provides accounting and regulatory reporting and possibly investment management services. The systems utilized are under the control of the Captive Manager. Access to the accounting package should be reviewed and should be limited to appropriate individuals. Often, the IT

Infrastructure is outsourced by the Captive Manager to a dedicated IT Service Provider or Cloud Services Provider. This entity may control or manage the access provided to the users. Insurance business systems may be managed and maintained by a different service provider than the accounting package. The IT Specialist will need to determine who does what and assess the adequacy of access controls in each entity involved. If the Captive or RRG has staff that sends or receives data with any service providers (including the Captive Manager), the access to all data and transfer process must be assessed.

Security controls should be in place to protect information from cyber breaches to prevent the inappropriate use of information. Strong security controls are of utmost importance for any entity that stores, accesses, displays or transmits data entrusted to the insurance company. The data that an RRG or Captive has may be different from a typical insurance company and may include fewer pieces of personal information, but this varies with the kind of insurance written and the information stored by each of the service providers. The challenge is in locating where the data is, whether it includes any sensitive information and what controls are in place at each service provider to assure adequate protection. RRGs for both legal and medical malpractice may have some quite sensitive information relating to legal actions. In some cases, the case information may be stored only on the systems owned and operated by the attorney(ies) handling the cases. Each IT Specialist will need to decide if those systems are in scope for the examination in conjunction with the EIC and the Insurance Department conducting the exam.

If the state performing the exam has adopted a Data Security Model Law, it should be determined whether the company being examined is exempt and if not, who is delegated to assure compliance with the regulation.

A Breach Response Plan should be in place for all service providers including reporting requirements to the Company, state and policy holders. Requirements should be clearly defined and kept current with regulations.

A Disaster Recovery Plan, which is just as important for Captives and RRGs as it is for any insurance company, should be in place and may be more complex due to the multiple systems that are involved. Each entity should have an up to date Disaster Recovery Plan that is tested annually. The enforcement of this will be up to the RRG, Captive or Captive Manager or possibly a Board of Directors or Board of Trustees.

Since the company is often entirely run by vendors, how Vendor Management is executed is of great importance. If the company being examined does not have employees, the Captive Manager is probably the most appropriate entity to be responsible for vetting third parties and their third parties and on down the line to ensure the appropriate controls are in place.

The service providers probably are not regulated by Insurance Departments and therefore may resist providing information to examiners. This is the biggest challenge for the IT portion of the Captive or RRG companies. The IT Examiner will need to discuss this with the EIC and the Department to assure that the regulations requiring cooperation will be available for distribution to the entities.

In some cases, the service providers may have SSAE 18 SOC 1, SOC 2 and SOC 3 reports to provide. It will be up to the IT Specialist to determine if these reports are sufficient to establish reliance on IT General Controls for the service provider and thus the company being examined. One approach is to ask the Captive Manager if the SOC reports are obtained and reviewed for all service providers on an annual basis and request evidence of the review. One service provider for a captive being reviewed said that they did not want to pay for a SOC Review. It was pointed out that each state in which the RRG or Captive is active can be asking the same questions, which in the end may be a much greater expense.

Case Number 3: Very small company with either a few employees or officers who track the business in the office on a spreadsheet or in an Access database – mostly RRGs.

In some ways, this group is the hardest to make an Examination Plan to follow. They are confident that they are doing fine with a spreadsheet to track participants. Claims are few as policy holders are reliable and very reputable. What is important is that the calculations and tracking of the few claims they have as well as the adequacy of the premium being charged are accurate and appropriately evaluated using the spreadsheets created for that purpose. Spreadsheets can usually be modified extensively including the functions being utilized. It is important to determine whether modifications to the spreadsheets are tracked and limited to persons with justification to modify formulas in spreadsheet and that changes are documented.

The tendency of the very small company is trusting all the policy holders as they are (or should be) being vetted prior to joining the group. RRGs are all about liability and each of the members/policy holders are invested in the success or failure of the RRG. It is usually based on trust and one of my mantras is trust is not a control. It is not about would you do it but about could you do it. When assessing a regular company, we look at User Developed Applications and we should apply the same criteria to the spreadsheets developed by the members of an RRG. They are professionals in their field but not in Information Technology. They are able to create a spreadsheet that can process and track their policies but are not thinking about information security and IT General Controls. Access and modifications to the spreadsheets should be limited and an audit log of changes should be maintained and reviewed. Backups of the spreadsheets should be monitored for success and encrypted to ensure that sensitive information is protected. Very few of the small companies are aware of security risks as they are concerned with their professions and maintaining quality. RRGs are limited to liability insurance, so are based on the competence of the members/policy holders.

There is usually a small office with a couple of people managing the entire operation. Sometimes they locate the server in the break room or lunchroom where everyone goes for lunch. The server is exposed to everyone who comes into the break room or the storage room or the main office. Servers today are small and can be carried out of an office. Strangers may be allowed in the office to work on equipment or just to make inquiries. It is recommended that the server be protected by Multiple Factor Authentication (MFA) such as a card and a PIN number. Often this can be accomplished without much additional cost.

The thin line we walk in these companies is to teach them the importance of IT General Controls being implemented for the protection of the policy holders and the company, while not being prohibitively expensive to the company. The policy holders set annual premiums to cover necessary expenses and it is important that security and IT General Controls costs be included in the necessary premium amount.

Much of this process is educating the company on the risk incurred compared to the cost of the controls.

We, as IT Specialists should keep our focus on the protection of the data entrusted to the companies and the controls in place to assure the reliability and accuracy of the information used to develop regulatory reports used by the departments and the examiners to determine solvency and ability to continue to be a going concern.

I take IT Reviews very seriously as all decisions made by a company are based on the information created from the data maintained.

Reporting observations/findings related to the Service Providers:

An additional difference occurs when reporting observations or findings that are noted during the review of the various service providers. The Company under review is the recipient of the IT Issues for a response. The findings are worded such that the IT Specialist is recommending that the Company discuss the issues with their providers and either suggest or require them to implement action to remediate the risk. Whether they suggest or require will depend on the severity of the risk. Each Company should be requiring a level of security for each service provider that maintains or has access to company data. If a discrepancy is noted in the level of security, the word require is appropriate. As usual, all observations/findings should be discussed with the EIC before being sent to the Company.

Please feel free to contact me and ask questions - jenny@jennan.com

About the Author

Jenny Jeffers is the owner of Jennan Enterprises located in Tallahassee; FL. Jennan Enterprises has provided Information services including system development, data conversion, training, Receivership IT Management, UDS data conversion and processing for both Receivers and Guaranty Associations and information system auditing for the insurance regulatory industry. During the past 16 years, the primary focus of Ms. Jeffers has been in the regulatory arena performing systems audits, data analysis, forensic data analysis and control risk assessment in both Life and Health and Property and Casualty companies for multiple state insurance departments. Her work with regulators involves both financial and market conduct exams.

Jenny maintains the designations of a Certified Information Systems Auditor (CISA – Information Systems Audit and Control Association), a Certified Fraud Examiner (CFE – Association of Certified Fraud Examiners) and an Automated Exam Specialist (AES – Society of Financial Examiners Designation) and is an active member of Society of Financial Examiners (serving on the Board of Governors and Executive Committee and as Chairman of the AES Committee), Insurance Examiners Regulatory Society, IAIR, Association of Certified Fraud Examiners, Project Management Institute, International Systems Audit and Control Association and the National UD Committee as well as NAIC Audit Software Working Group. Ms. Jeffers serves on several committees within these organizations with the primary focus of education of examiners in the importance of the role of IT in the insurance industry. As a member of the SOFE CDS Program Committee she provides the speakers for the IT track for the CDS

PwC NAIC Newsletter

Spring 2023

The National Association of Insurance Commissioners met in Louisville, Kentucky for the Spring National Meeting. This newsletter contains information on activities that occurred in meetings from January 31, 2023 to April 28, 2023. For questions or comments on this Newsletter, please feel free to contact us at the address given on the last page.

In this issue

Executive summary

- The Statutory Accounting Principles Working Group (SAPWG) exposed additional revisions to SSAPs 21R, 26R, 43R, and 86. The most notable revision is the addition of the concept of "nominal interest rate adjustments" which is expected to increase the scope of debt instruments that will be considered bonds, including many sustainability-linked bonds.

- SAPWG exposed a proposal to extend INT 22-02 to remain effective through second-quarter 2023. In INT 22-02, SAPWG concluded that a reasonable estimate of the effect of the corporate alternative minimum tax cannot be made and provided a limited-time exception to the valuation allowance and DTA calculations under SSAP 101 and Type I subsequent event requirements in SSAP 9.

- The RBC Investment Risk and Evaluation Working Group adopted structural changes to add new lines for residual tranches for all types of structured securities reported on Schedule BA and added new lines for residual tranches to the sensitivity test for total authorized control level to the Life RBC Blanks for year-end 2023 RBC reporting. In addition, the working group exposed for comment a proposed C-1 RBC factor of 45% and a sensitivity factor of 10% for residual tranches. This is intended to be an interim solution to address concerns of potential RBC arbitrage involving residual tranches in structured assets. The working group also continued to discuss its work on developing an approach for determining RBC charges specifically for CLOs.

- The Life RBC Working Group adopted a structural change to the newly adopted C-2 mortality risk calculation component to add a new category for group permanent life for 2023 year-end RBC filings. In addition, the working group previously proposed a new financial statement footnote to create a direct link to the financial statements to calculate the net amount at risk for the C-2 RBC mortality risk categories which was exposed at the spring meeting by the Blanks Working Group (2023-09BWG). The working group also proposed an amendment to the Life RBC formula to recognize collateral that is held by the cedant in "custody control accounts".

- The Valuation of Securities Task Force (VOS/TF) deferred the controversial "Structured Equity and Funds" proposal which aimed to eliminate preferential RBC treatment compared to if the insurer owned the underlying investments directly. Separately, VOS/TF amended the P&P Manual to include CLOs as financially modelled securities as of January 1, 2024 while the modeling methodology continues to be developed.

- The Blanks Working Group exposed several proposals including to: split Schedule D, Part 1 into two sections for issuer credit obligations and for asset-backed securities related to the SAPWG bond project, add a new financial statement footnote to the Life annual statement to obtain information for the new C-2 RBC mortality risk charges, add additional instructions to disclose more information on investment income related to changes to SSAP 34 adopted by SAPWG, and modify the instructions for the footnotes and Schedule DB to reflect changes to SSAP 86 adopted by SAPWG related to excluded components.

- The Life Actuarial Task Force adopted and exposed several updates including an exposure that would reduce reporting lag associated with the VM-50/VM-51 mortality experience data collection process from two years to one year beginning in 2025.

Innovation, cybersecurity, technology, and privacy initiatives

During the Spring National Meeting, the Innovation, Cybersecurity and Technology Task Force discussed multiple issues around the accelerating use of technology within the insurance industry, as well as concerns on the use of data related to that technology. In addition to hearing from its working groups, the task force's Collaboration Forum on Algorithmic Bias provided an update on the work plan for moving forward on the development of a regulatory framework. The committee plans to draft a regulatory framework for the use of artificial intelligence by the insurance industry in the form of a model bulletin that will be principles based (versus prescriptive), rely on external objective standards, and place responsibility on licensees to conduct appropriate diligence with respect to third-party party data and model vendors versus directly regulating. An exposure draft of the framework is anticipated to be ready for public comment by early summer. The committee also heard a report on the proposed Colorado Algorithm and Predictive Model Governance Regulation and a presentation on North Dakota's use of blockchain methodology for data calls.

In addition, as part of the Spring National Meeting, the task force received the following significant reports from its working groups:

Cybersecurity Working Group – The working group's most significant project for 2023 is the development of a cybersecurity response plan to aid states with responding to cybersecurity events occurring at regulated entities and they expect to have a document available for regulator review before the Summer National Meeting.

Big Data and AI Working Group – Artificial intelligence (AI) and machine learning (ML) tools can assist in customer engagement, rating, underwriting, claims management, and fraud detection and insurers are investing in these tools for better decision making and to remain competitive. State insurance regulators have expressed concerns about fairness, unintended discrimination, and lack of transparency related to these tools. The working group has been conducting surveys to understand the risk and exposure from the use of AI/ML and to inform a regulatory approach for overseeing and monitoring this activity. The working group met at the Spring National Meeting to discuss the results of the home insurance survey and upcoming life insurance survey as well as industry feedback on draft model and data regulatory questions for the evaluation of internal and third-party data and model vendors. A revised draft is expected at the end of May. For AI, an important topic continues to be how regulators can ensure that AI is not used in an unfairly discriminatory way. One idea the committee is considering is the development of an independent modeling data set for testing company algorithms for unfair discrimination and the committee will plan to engage with the industry to seek input and feedback on this topic.

Privacy Protections Working Group – Last year, the working group received approval to move forward with the creation of one new model to replace existing privacy models #670 (NAIC Insurance Information and Privacy Protections Model Act) and #672 (NAIC Privacy of Consumer Financial and Health Information Regulation) rather than to update them. The draft of new model #674 was exposed for comment at the end of January until April 23. The working group discussed comments received at the Spring National Meeting and will continue to discuss and collaborate on language at the NAIC Summer National Meeting.

E-Commerce Working Group – The working group surveyed the states to understand what exceptions to state law or regulations were implemented during the pandemic as well as surveying the industry, consumers, and interested parties about what impediments exist that impede their ability to conduct business electronically. A framework was developed based on the analysis of those survey responses and was exposed for comment. The working group intends to schedule open meetings to discuss feedback received during the comment period.

Innovation and Technology Working Group – The working group is focused on understanding the current innovations and technologies used by regulators, insurers, and third parties.

NAIC Legislative Update - The NAIC legislative team heard updates from Colorado related to its proposed governance and risk management regulation SB21-169.

- Colorado Legislation SB21-169: Draft Proposed Governance and Risk Management Regulation is designed to protect Colorado insurance consumers from insurance practices that result in unfair discrimination and applies broadly to insurers that use external consumer data and information sources ("ECDIS") as well as algorithms and predictive models that use ECDIS. The regulation requires carriers to test whether ECDIS and the algorithms and predictive models utilizing ECDIS results in unfairly discriminatory outcomes and to establish a risk management framework. Carriers will need a runway to build the necessary infrastructure to comply with the regulation. Next steps include exposing a revised draft for an additional round of comments and exposing a companion testing regulation.

Statutory Accounting Principles Working Group

Significant actions taken by the SAP Working Group are summarized below. (Appendix A to this Newsletter summarizes all actions taken by the working group.) Comments on exposed items are due June 9 unless stated otherwise.

Newly adopted guidance

SSAP 34 - Interest Income Disclosure Update (#2022-17): Two new financial statement disclosures related to investment income due and accrued are required beginning with year-end 2023 reporting. The first requires disclosure of the gross, nonadmitted and admitted amounts of interest income due and accrued. The second requires disclosure of any deferred interest and cumulative amounts of paid-in-kind (PIK) interest included in the current principal balance. The disclosure of deferred and PIK interest is in the aggregate; however, this information is expected to be collected for each investment in the Annual Statement when blanks changes related to the principles-based bond proposal become effective in 2025. Impacted insurers may need to develop new processes and controls to aggregate this information to support the disclosure.

SSAP 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (#2022-15): In March 2023, SSAP 25 was revised to clarify any invested asset held by a reporting entity which is issued by an affiliated entity, or which includes the obligations of an affiliated entity is an affiliated investment.

Significant exposures/discussions

Principles-based bond proposal project (#2019-21): The working group considered comments received on the exposures made at the Fall National meeting, and exposed additional SSAP revisions at the Spring National Meeting, including revisions to SSAPs 21R, 26R, 43R, and 86. Highlights of the most recently proposed revisions include:

- Transition - Presentation (SSAP 26R/43R): The proposed effective date of January 1st, 2025 is unchanged. However, revisions clarify that the transition guidance shall be applied prospectively from that date and prior periods included in comparative disclosures will not need to be restated.

- Nominal interest rate adjustments (SSAP 26R): One of the requirements for a debt instrument to represent a creditor relationship is that it must have pre-determined principal and interest payments with contractual amounts that do not vary based on the performance of any underlying collateral value or other non-debt variable. Revisions were made to define "nominal interest rate adjustments" and clarify that such adjustments are not intended to preclude bond treatment. Prior to this clarification, these adjustments may have been considered contractual amounts that vary based on a non-debt variable. The proposed definition is excerpted below:

> "Nominal interest rate adjustments are those that are too small to be taken into consideration when assessing the investment's substance as a bond. Nominal adjustments are not typically influential factors in an investors' evaluation of investment return and are often included to incentivize certain behavior of the issuer. An example would include sustainability-linked bonds where failure to achieve performance metrics could cause interest rate adjustments. In general, interest rate adjustments that adjust the total return from interest by more than 10% (e.g., >0.4% for a 4% yielding bond),

would not be considered nominal. Further, any such adjustments that cause an investment to meet the definition of a structured note would not be considered nominal."

- Timing of assessments (SSAP 26R/43R): Revisions were made to clarify that assessment of whether a debt instrument is a bond shall be performed as of the origination date. Prior to the revision the transition guidance may have been interpreted to require the assessment to take place as of the date of acquisition.

- Residual tranches scope (SSAP 21R/43R): Revisions were made to exclude "residuals" from the scope of 43R and capture them in the scope of 21R. The proposed revisions to 21R define residuals as residual tranches or interests from securitization tranches, beneficial interests and loss positions that lack contractual payments along with substantive credit enhancements.

- Residual measurement (SSAP 21R): The exposure proposes that residuals initially be measured at cost and subsequently be measured at the lower of amortized cost or fair value; however, staff specifically requested industry input on how residual tranches have been amortized. The exposure takes a similar approach to OTTI, including a requirement for residuals to be assessed for OTTI on an ongoing basis, but requesting comments from industry on how OTTI has been assessed for these investments.

Proposed nullification of INT 03-02: Modification to an Existing Intercompany Pooling Arrangement (#2022-12): At the Spring National Meeting the Working Group re-exposed the proposal with a proposed effective date of year-end 2023 and requested Interested Parties to comment with specific examples that demonstrate their concerns. Interested Parties previously expressed concerns, including among others, that any realized investment gains resulting from a transfer would have to be deferred at the common parent reporting entity level, that transactions which currently qualify for prospective accounting per paragraph 36.d of SSAP 62R would no longer do so due to a gain being recognized on the transaction, and that nullification of the INT would result in inconsistent interpretation of the guidance.

SSAP 21R – Collateral for Loans (#2022-11): Since the fall, discussion of this agenda item has been focused on collateral loans which are backed by investments that are required to be measured using the equity method being applied to audited financial statements (i.e., investments in the scope of SSAP 48 or SSAP 97). At the Spring 2023 National Meeting, the Working Group exposed revisions to SSAP 21R which would require the proportionate audited equity valuation (i.e., equity method) to be used for the comparison of the adequacy of the pledged collateral. If adopted, this clarification would require the financial statements of the collateral investment to be audited and change how the collateral is measured from fair value to the equity method.

New Market Tax Credits / Equity Investments for Tax Credits (#2022-14): NAIC staff recommended, and the Working Group directed NAIC staff to proceed with drafting revised statutory accounting guidance and a related issue paper to expand the guidance in SSAP 93 for tax credits, as well as to draft revisions to SSAP 94—Transferable and Non-Transferable State Tax Credits for future Working Group discussion. NAIC staff intends to consider the feedback from interested parties on the discussion document exposed at the Fall National Meeting as well as the revised FASB guidance (ASU 2023-02 Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method was subsequently issued on March 29, 2023), in updating the proposed revised statutory accounting guidance for subsequent exposure consideration.

Negative IMR (#2022-19): At the Spring National Meeting, the Working Group discussed this item and expressed an intent to develop a short-term solution for 2023 reporting along with a long-term solution. With those goals, the Working Group directed staff as follows:

- Recommend a referral to the Life Actuarial Task Force to consider the asset adequacy implications of negative IMR. Items to include: 1) developing a template for reporting within asset adequacy testing (AAT); 2) considering the actual amount of negative IMR that is admitted to be used in the AAT; 3) better consideration of cash flows within AAT (and documentation), as well as any liquidity stress test (LST) considerations; 4) ensuring that excessive withdrawal considerations are consistent with actual data (sales of bonds because of excess withdrawals should not use the IMR process); and 5) ensuring that any guardrails for assumptions in the AAT are reasonable and consistent with other aspects.

- Recommend a referral to the Capital Adequacy Task Force for the consideration of eliminating any admitted net negative IMR from total adjusted capital and the consideration of sensitivity testing with and without negative IMR.

- Develop guidance for future Working Group consideration that would allow the admission of negative IMR up to 5% of surplus using the type of limitation calculation similar to that used for goodwill admittance. The guidance should also provide for a downward adjustment if RBC ratio is less than 300. (Subsequent to the meeting, the Working Group exposed INT 23-01T; see below for details.)

- Review and provide updates on any annual statement instructions for excess withdrawals, related bond gains/losses and non-effective hedge gains/losses to clarify that those related gains/losses are through asset valuation reserve, not IMR.

- Develop accounting and reporting guidance to require the use of a special surplus (account or line) for net negative IMR.

- Develop governance related documentation to ensure sales of bonds are reinvested in other bonds.

- Develop a footnote disclosure for quarterly and annual reporting.

Much of the discussion between regulators was focused on what safeguards/guardrails would be in place if negative IMR was allowed to be admitted and this came through in the direction provided to staff. Due to some of those potential guardrails being outside the direct authority of the Working Group (e.g., referral to Capital Adequacy Task Force), the development of a long-term solution is unlikely to be accomplished quickly.

SSAP 7 - Net Negative (Disallowed) IMR (INT 23-01T): After the Spring National Meeting, the Working Group exposed INT 23-01T as a short-term solution to the negative IMR concerns expressed in agenda item #2022-19 (discussed above). The exposed INT i) allows for net negative (disallowed) IMR to be admitted if certain criteria are met, ii) provides instruction on how to report it in the financial statements, and iii) requires new disclosures if net negative (disallowed) IMR is admitted. Key provisions of the INT include:

- <u>Separate Accounts</u>: The provisions of the INT do not allow for separate accounts to admit net negative (disallowed) IMR beyond what is allowed under current guidance. The admittance of any net negative (disallowed) IMR in the general account will not impact the comparison of general account and separate account IMR as it shall be done on a gross basis (i.e., excluding any general account admitted net negative IMR).

- <u>Minimum RBC</u>: Reporting entities with a 300% or lower RBC are not permitted to admit net negative (disallowed) IMR.

- <u>Limitation relative to surplus</u>: Admitted amount is limited to 5% of the reporting entity's adjusted general account capital and surplus. Similar to the goodwill limitation, surplus is adjusted to exclude goodwill, EDP equipment and operating system software, deferred tax assets, and admitted net negative IMR.

- <u>Limitation relative to reinvestment</u>: Admitted amount is limited to IMR generated from losses incurred from the sale of bonds, or other qualifying fixed income investments, that were reported at amortized cost prior to the sale, and for which the proceeds of the sale were immediately used to acquire bonds, or other qualifying fixed income investments, that will be reported at amortized cost. This limitation intentionally excludes IMR generated from derivative losses on derivatives reported at fair value. See below for further discussion on this item.

- Reporting – other-than-invested asset: All net negative IMR (admitted and non-admitted) shall be reported as a write-in to miscellaneous other-than-invested asset (named as "Disallowed IMR") on the asset page.

- Reporting – special surplus: An amount equal to the admitted net negative (disallowed) IMR shall be allocated to special surplus.

- Disclosure – derivatives limitation: Reporting entities that have allocated gains/losses to IMR from derivatives that were reported at fair value shall disclose the non-amortized impact to IMR from these allocations separately between gains and losses. This disclosure shall illustrate the removal of these balances from the total general account IMR to determine the net negative amount that is permitted to be admitted.

- Disclosure – surplus limitation: Reporting entities shall disclose the gross negative (disallowed) IMR, the amounts of negative IMR admitted and nonadmitted, adjusted capital and surplus (as described above in the Limitation relative to surplus) and the percentage of adjusted capital and surplus for which the admitted negative IMR represents.

The exposed INT also included commentary which indicated how the long-term solution may impact IMR related to derivatives and separate accounts. The INT describes how some reporting entities have allocated derivative losses to IMR for derivatives that were reported at fair value throughout the derivative life (i.e., they did not qualify as effective hedges under statutory accounting). Such amounts are not eligible to be admitted per the INT (see Limitation relative to reinvestment above); however, the INT goes on to say that this practice is not in line with the original intent of the IMR guidance in SSAP 86 or the annual statement instructions. While the proposed INT would not impact this industry interpretation, SAPWG intends to consider it as part of the long-term proposal.

SAPWG observed that current guidance which requires insulated and non-insulated separate account blanks was not in effect when the IMR annual statement instructions were drafted. As part of the long-term solution, SAPWG intends to assess the concepts of insulated separate accounts and whether the balances of the general account should have any influence on how IMR is reported in those separate account statements.

SSAP 43R – CLO Financial Modeling (#2023-02): The Working Group exposed revisions to add collateralized loan obligations (CLOs) to the financial modeling guidance and to clarify that they are not "legacy securities." The methodology to model CLOs is still being developed by VOS/TF, but guidance that permits the SVO to model CLOs has been adopted and will be followed once CLOs begin to be financially modeled. Refer to the Valuation of Securities Task Force summary for additional details.

SSAP 51R, 59, and 61R - New C-2 Mortality Risk Note (#2023-03): The Working Group exposed a new financial statement note related to the Life Risk-Based Capital Working Group's project to modify C-2 RBC mortality risk charges. Comments on this item were due by May 5. See the Life RBC and Blanks summary for further information.

INT 22-02 Third Quarter 2022 through First Second Quarter 2023 Reporting of the Inflation Reduction Act - Corporate Alternative Minimum Tax (CAMT): On April 12, 2023, SAPWG exposed a proposal to extend INT 22-02 to remain effective through second-quarter 2023 (the comment period ended May 5, 2023). Separately, the Working Group directed staff to work with industry on developing guidance for the reporting of the CAMT (Agenda Ref# 2023-04, Corporate Alternative Minimum Tax Guidance).

Risk-based capital

Investment RBC

The Risk-Based Capital Investment Risk and Evaluation (Investment RBC) Working Group was created to perform a "comprehensive review" of the RBC investment framework in light of a significant number of investment-focused proposals from other task forces and working groups. The Financial Condition Committee handed off two projects: 1) consider a second phase of the bond factors for structured securities and other asset-backed securities, including collateralized loan obligations, and 2) consider specific RBC charges for residual tranches that will now be reported on Schedule BA. Following the adoption of new bond factors for the life RBC formula and as the industry shifts towards more structured securities, regulators believe that they need to start thinking about the increased tail risk of these investments more explicitly in the RBC formula.

The working group continues to discuss the items referred to by the Financial Condition committee including a long-term focus developing a scheme for determining RBC charges for CLOs and an interim focus on addressing concerns of potential RBC arbitrage involving residual tranches in all types of structured assets.

During the spring, the working group adopted structural changes to add new lines for residual tranches for all types of structured securities reported on Schedule BA and AVR and added new lines for residual tranches to the sensitivity test for total authorized control level to the Life RBC Blanks for year-end 2023 RBC reporting. In addition, the working group exposed for comment a proposed C-1 RBC factor of 45% and a sensitivity factor of 10% for residual tranches. Comments are due May 12. The working group noted that while this is for Life RBC only for 2023, they do plan to address Health and P/C RBC next year. During the spring, the working group continued to discuss a recommendation from VOS/TF to permit the Structured Securities Group (SSG) to financially model CLOs for the assignment of NAIC designations and their suggestion to assign new NAIC designations categories (e.g., 6.A, 6.B and 6.C) with recommended C-1 RBC factors of 30%, 75% and 100%, respectively. There were no exposures made during the spring and more discussion needs to occur. See further discussion in the VOS/TF Summary below.

Life RBC

C-2 Mortality Risk – Previously, the Life RBC Working Group adopted structural updates for more granular product categorizations for C-2 Mortality (LR025) risk ahead of the adoption of the new factors for 2023 RBC reporting. The categories include life policies with pricing flexibility (e.g., participating whole life insurance), term life without pricing flexibility (e.g., level term insurance with guaranteed level premiums) and permanent life without pricing flexibility (e.g., universal life with secondary guarantees) plus group and credit with remaining rate terms 36 months and less, group and credit with remaining rate terms over 36 months and FEGLI/SGLI. These six categories are an expansion over the current two categories of Individual & Industrial and Group & Credit. The Life RBC Working Group also previously adopted the related instructional and Academy-proposed factor changes necessary to fully implement the revised morality risk proposal. The factors are tiered into three "buckets" based on reserves held, i.e., higher charges for the first $500 million, and lower charges for the next $24,500 million and over $25,000 million (compared to the current four tiers). Per the Academy, the proposed factors reflect mortality improvement compared to the current RBC mortality factors, which were established in the early 1990s.

The Life RBC working group has been discussing their list of additional future changes and instructional updates to be made in 2023 based on items identified during the adoption process of the new factors. During the spring, the working group adopted a structural change to the newly adopted C-2 mortality risk calculation component to add a new category for group permanent life with and without pricing flexibility for 2023 year-end RBC filings. In addition, the working group previously proposed a new financial statement footnote to create a direct link to the financial statements to calculate the net amount at risk for the C-2 mortality risk categories. That footnote was subsequently exposed by the Blanks Working Group

(2023-09BWG) during its spring meeting. See further discussion in the Blanks summary. The working group also exposed for comment an amendment to the Life RBC formula to recognize collateral that is held by the cedant in a "custody control account". These accounts are noted as providing the same protections as a reinsurance trust arrangement. Comments are due June 2nd.

Valuation of Securities Task Force

The Valuation of Securities Task Force (VOS/TF) discussed the following significant projects and issues.

Financial modeling of collateralized loan obligations (CLOs): In February 2023, the VOS/TF adopted an amendment to the P&P Manual to include CLOs as a financially modeled security with an effective date of January 1, 2024 (the amendment had been re-exposed during the Fall National Meeting). While this will allow the SSG to assign NAIC designations, the modeling methodology to determine those designations remains under development. This is the latest action taken to address NAIC staff's view that the use of CLOs under current rules may allow for RBC arbitrage.

Structured Equity and Funds: At the Spring National Meeting, VOS/TF deferred a decision on a controversial proposed amendment to the P&P Manual related to certain investment structures, which in the SVO's view allow for RBC arbitrage due to the investments being characterized as filing exempt. The proposed amendment would have i) defined such investments, ii) made them ineligible for filing exemption, and iii) directed the SVO to assign NAIC Designations and Categories utilizing a look-through assessment. While the amendment was not adopted, VOS/TF took two related actions. First, staff were directed to send a referral to SAPWG to request that it consider the definition of structured equity and funds in its residual tranche guidance. Second, in consideration of comments received indicating that the scope of the proposed amendment was unnecessarily broad compared to the perceived concern with a subset of filing exempt investments, the VOS/TF directed staff to draft a separate amendment. The amendment is expected to outline recommended procedural steps for reviewing filing exempt investment securities for which SVO staff have concerns about the assigned NAIC Designation and the steps insurers could take to clarify and rebut those concerns.

Qualified U.S. Financial Institutions: VOS/TF exposed and subsequently adopted a P&P Manual amendment to update the Notice of Credit Deterioration process for the List of Qualified U.S. Financial Institutions ("QUSFI"). The SVO maintains the List of QUSFI which indicates the financial institutions eligible to issue letters of credit which can be used to reduce an insurer's liability when ceding reinsurance to certain assuming insurers. Prior to the amendment, the P&P Manual called for removing a financial institution from the list if certain rating downgrades occurred; however, it did not address situations when regulatory action might be taken prior to downgrade (e.g., recent actions taken by bank regulators). After the amendment, if a financial institution is closed by and/or placed in receivership or conservatorship, or notice is given of such action by its primary regulator, the financial institution will be removed from the list.

Blanks Working Group

The working group did not meet at the Spring National Meeting but did meet in March and took the following significant actions. All adopted revisions and exposed proposals are shown on the Blanks Working Group webpage.

Adopted proposals

- Revise Schedule H, Part 5 to remove the 5% of premiums filing exemption which would require both Property Casualty and Life filers to file the Schedule H, Part 5. (2022-15BWG).

Exposed proposals

The working group also exposed or re-exposed for comment the following significant new proposals with a comment period ended April 28 unless otherwise noted:

- Split the Schedule D, Part 1 into two sections; one for Issuer Credit Obligations (SSAP 26R) and one for Asset-Backed Securities (SSAP 43R) related to the SAPWG bond project. Also updates other parts of the annual statement that reference the bond lines. Comments are due June 30. (2023-06BWG).

- Add a new financial statement footnote, Note 37 – *Life Insurance Net Amount at Risk by Product Characteristics*, to the Life annual statement to obtain from the financial statements the information needed for the new life C-2 RBC mortality risk charges. For more information see Life RBC summary. (2023-09BWG).

- Add additional instructions and illustration to be data captured in Note 7 – *Investment Income* to disclose more information on interest income related to changes to SSAP 34 – Investment Income Due and Accrued adopted by SAPWG (2023-11BWG and SAPWG 2022-17). See SAPWG summary for more information.

Modify the instructions for Note 8 and Schedule DB to reflect changes to SSAP 86 adopted by SAPWG and disclose and data capture information related to excluded components. (SAPWG 2021-20). (2022-17BWG Modified)

Financial Stability Task Force and Macroprudential Working Group

Private equity considerations – Previously, the Macroprudential Working Group adopted a final document entitled "Plan for the List of MWG Considerations - PE Related and Other." The document identifies 13 types of risks related to private equity ownership of insurers, such as companies structuring agreements to avoid regulatory disclosures or requirements and operational, governance and market conduct practices that are influenced by different priorities and level of insurance industry expertise. The final document also includes documentation of "regulatory responses" to the 13 types of risk listed, interested party comments, and referrals to other NAIC committee groups. During the Spring National Meeting, the work group heard an update on the referrals and specifically related to reinsurance risks, exposed for comment an optional cross-border reinsurance worksheet to assist regulators in reviewing "complex affiliated reinsurance transactions".

Macroprudential Risk Assessment Process – The task force and working group previously adopted their final Macroprudential Risk Assessment Process document, which has a key objective to "identify and assess industry-wide insurance risks." The guidance includes both qualitative and quantitative assessment factors to reach baseline assessments of industry exposure to various macroprudential risks. The four assessment levels are High, Moderate-high, Moderate-low or Low. The NAIC's full Macroprudential Risk Assessment report it is still being finalized but the key topics included in the report are; investment trends, changes in ownership, increasing catastrophe risk losses, macroeconomic trends such as inflation and interest rates, cyber security and insurance.

Climate and Resiliency Task Force

The Climate and Resiliency Task Force met at the Spring National Meeting and discussed state actions to incentivize mitigation and resiliency and discussed international updates from the International Association of Insurance Supervisors (IAIS) Climate Risk Steering Group's three workstreams. Previously, the Financial Stability Board (FSB) published its final report on supervisory and regulatory approaches to climate-related risks. From a federal update, the NAIC continues to support the federal Disaster Mitigation and Tax Parity Act.

Solvency Workstream – The Solvency Workstream developed three referrals that it continues to track the status on and will report on publicly once the information is available. The referrals—to the Property and Casualty Risk-Based Capital (E) working Group, Financial Analysis Solvency Tools (E) Working Group, and the Financial Examiners Handbook (E) Technical Group—provide high-level principles for the groups to consider and develop as appropriate for inclusion in relevant financial solvency regulation manuals. On February 1st, the Solvency Workstream heard a presentation from the Federal Reserve on their recently exposed, proposed climate scenario analysis exercise and to discuss members initial views on the role of climate scenario analysis as a financial oversight tool for US regulators and are in the process of surveying members and interested regulators on whether the workstream should look at the development or incorporation of climate scenario analysis with regard to oversight tools. The workstream is also considered what the US approach should be in relation to climate stress testing.

Restructuring Mechanisms Working Group

For several years the Restructuring Mechanisms Working Group has been working to develop a white paper to summarize the various industry wide processes for insurance companies to restructure liabilities with finality, primarily through the use of two types of transactions: insurance business transfer (IBT) and corporate division (CD). During the spring, the working group continued to discuss comments received. The is not being re-exposed at this time however, the Subgroup did re-expose until April 26 its draft Foundational Principles and Best Practices Procedures for IBT/ Corporate Divisions for regulator review of proposed restructuring transactions. The subgroup also discussed several proposed options for modifying the P/C RBC formula for "runoff companies."

Principles-based reserving

Valuation Manual amendments

During LATF calls between January 2023 and 2023 Spring National Meeting several Amendment Proposal Forms (APFs) and related guidance were discussed, exposed and/or adopted as follows:

Adopted guidance

APF 2022-09 clarifies documentation items within VM-31 and reflects changes to be consistent with VM-21, including VM-31 sections on internal controls, aggregate impact of approximation and simplifications, scenario generation, mortality improvement and projection period.

APF 2022-10 reflects minor updates to VM-20 regarding the ULSG exclusion tests for UL policies with a non-material secondary guarantee.

APF 2023-01 amends VM-21 Section 4.D.1.a so that all definitions of the value of the assets at the start of the projection consistently include the allocated amount of PIMR attributable to the assets selected.

APF 2023-02 adds minor updates to various VM-31 disclosure requirements.

APF 2023- 03 parts 3, 4 and 5 add consideration to VM-20 section 7.E.2 to the company's assumed cost of borrowing [part 3], clarify the requirement to reflect the hedge modeling error/insufficiency in section 7.K.3 [part 4], and adds to section 9.A.4 consideration of risk factors other than interest rates and equities that are stochastically modeled [part 5].

Exposed guidance

APF 2021-08 proposed changes would reduce reporting lag associated with the VM-50/VM-51 mortality experience data collection process from two years to one year beginning in 2025. If adopted, the 2024 data collection would include experience in 2022 and 2023, and the 2025 data collection would include experience in 2024. This APF was originally brought forth in 2021 but was tabled at that time until the new NAIC data collection process was more established. The exposure period ended April 21.

APF 2023-03 parts 1 and 2 would update VM-20. Part 1 updates section 3.B.5.c.ii.4 so that the formula for calculating the NPR for ULSG based on the SG to be consistent with the formula for calculating the NPR for ULSG disregarding the SG. Part 2 adds an aggregate cash surrender value floor for scenario reserves before calculating the CTE70 reserve to section 5.B.3. The comment period ended April 14.

APF 2023-04 proposed changes clarify the company documentation required to support the assertion that "company experience mortality rates shall not be lower than the mortality rates the company expects to emerge" in PBR Actuarial Report under VM-31 Section 3.D.3.l.iv. The comment period ended March 23.

APF 2023-05 proposed changes would revise the hedge modeling language in VM-21 and VM-31 to address index credit hedging. The proposed changes borrow heavily from the draft VM-22, with a goal of consistency between the two. The exposure period ended April 19.

Other VM Project Updates

VM-22 - PBR for fixed annuities

LATF heard an update from the VM-22 Subgroup on activities related to fixed annuity PBR. The update began with a brief overview of PBR – its history and structure – and continued with the targeted timeline for development of VM-22.

Field testing is targeted for 2024 and adoption in 2025, with a voluntary effective date of 1/1/2026 and a mandatory effective date of 1/1/2029. This timeline assumes the economic scenario generator is fit for this purpose by the beginning of the planned field test.

Upon adoption, the standards will be effective for new business only and will not apply to guaranteed investment contracts, funding agreements, or stable value contracts. Retrospective adoption and broadened scope will be considered later, perhaps along with development of a principles based capital methodology. A proposed PBR exception would exempt companies with less than $1B of fixed annuity statutory reserves gross of reinsurance.

The subgroup began review of comments on the second exposure draft earlier this month and plans to finish updates by the end of June. Of nearly 200 comments in three comment letters, all but about 30 are believed to be non-controversial.

Life Actuarial Task Force

Actuarial Guidelines

AG53 Review plan

LATF heard an update regarding the review plan of Actuarial Guideline LIII (AG53). The Valuation Analysis (E) Working Group (VAWG) will review the AG53 AAT templates submitted by the companies. LATF members view the company submissions as an important step to begin conversations between regulators and companies.

Other LATF Activity

Presentations on the Impact of a Rising Interest Rate Environment

The Society of Actuaries gave a presentation to LATF on the impact of a rising interest rate environment, focused specifically on the unique features of life insurance products and dynamic lapse rate development in asset adequacy testing.

Following the presentation, regulators moderated a round-table discussion with representatives from four companies. Panelists indicated their companies have been performing sensitivity testing to gauge the impact of a rising interest rate environment in asset adequacy testing. The co-occurrence of rising interest rate and pandemic phasing out clouds experience studies on policyholders responding to the rising interest rate. Panelists indicated it is difficult to single out the interest rate impact on the increased lapse behavior recently. The companies will continue to stay disciplined on liquidity management and active ALM to manage interest risks.

Economic scenario generator implementation project

At the Spring National Meeting in Louisville, LATF members received updates on the economic scenario generator field test results.

Purpose: Quantitative information from the VM-21/C3 Phase II field test was summarized to understand the impact on reserves and capital, evaluate the impact of hedging programs across field test scenario sets, review the range of results across field test participants, compare the stability of results over time, and inform regulator decision-making on model and calibration choices.

Key Limitations: The accuracy and reliability of the results are ultimately dependent on the quality of participant submissions. The field test reserve and/or capital participant analytics can be strongly dependent on a subset of the participants. Results for the different field test runs include varying numbers of participants corresponding to the levels of participation for that run. Four legal entities were excluded from the analysis due to results that did not seem reasonable to the NAIC. Field test results may not be fully representative of company results post implementation of the new scenarios, as companies did not make changes to their models to account for changes in the file test scenario sets.

High level observations: There was a wide range in the reserve and capital impacts across the participating companies. Additional review of individual company results in a regulator-only session may provide a more complete understanding of the underlying factors behind the range of results. The field test runs generally produced increases in reserves and capital. However, a minority of participants had substantial reserve and/or capital decreases for some of the runs. A number of companies commented that guaranteed benefits were out-of-the-money due to the economic environment, and that field test impacts would have been larger if a less favorable environment had been tested. The main drivers of the field test results were hedging, relative importance of equity returns vs. interest rates, distribution of guaranteed benefit types, use of proprietary economic scenario generators, hedge costs, and company-specific modeling assumptions.

Next Steps: The NAIC plans to present economic scenario generator field test results for VM-20 and C3

Phase I to LATF in the next 1 – 2 months after the Spring National Meeting. Additional time for follow-up discussions may be necessary. Regulators will continue to work with interested parties in economic scenario generator drafting groups to continue progress on reserve/capital framework specific implementation tasks.

The Life Actuarial (A) Task Force will engage with the American Academy of Actuaries and other interested parties to decide on stylized facts and acceptance criteria ahead of a recalibration of the economic scenario generator and a second field test.

Materials are posted on the NAIC website under the Economic Scenarios section of the Principle-Based Reserving webpage.

VM-20/VM-21 Economic Scenario Generator Technical Drafting Group

LATF members received a short update on activities of the technical drafting group. The directives for the Economic Scenario Generator technical drafting group are to recommend an Economic Scenario Generator governance framework (frequency, metrics, disclosures, and other specifics for ongoing monitoring as well as a related framework for determination, evaluation, and documentation of updates) consistent with model governance best practices and to consider how ASOP 56, Model Governance Checklist, and Model Governance Practice Notes specifically apply to the Economic Scenario Generator maintenance and update Process. A VM-20/VM-21 Economic Scenario Generator Technical Drafting Group Topics, Timing, and Decision Points document was exposed on March 2, 2023; the comment period ended March 23, 2023. The list of topics includes the stochastic exclusion ratio test, deterministic reserve, scenario picker tool, company-specific market paths and alternative methodology. The drafting group will continue to meet in April.

The 2023 Summer National Meeting of the NAIC is scheduled for August 12-16 in Seattle, Washington. We welcome your comments regarding issues raised in this newsletter. Please provide your comments or email address changes to your PwC LLP engagement team, or directly to the NAIC Meeting Notes' editor, Jen Abruzzi, at jennifer.abruzzi@pwc.com.

Appendix A

This table summarizes actions taken by the SAP Working Group since the Fall National Meeting on open agenda items. For full proposals exposed and the status of agenda items that were not actioned during the period, see the SAP Working Group webpage.

Issue/ Reference #	Status	Action Taken/Discussion	Proposed Effective Date
SSAP 86 – Statutory Issue Paper No 16X (#2017-33)	Adopted	Adopted the exposed Issue Paper 16X—Derivatives and Hedging to detail the historical actions resulting in new SAP concepts within SSAP 86—Derivatives	N/A
Principles-based bond proposal project (#2019-21)	Re-exposed	Exposed revisions to SSAP 26R—Bonds, SSAP 21R, SSAP 43R, and other impacted SSAPs to refine guidance for the principles-based bond project. Directed NAIC staff to continue interim discussions with interested parties.	January 1, 2025
Conceptual Framework – Updates (#2022-01)	Re-exposed	Exposure includes revisions that defer to topic-specific SSAP guidance that varies from the liability definition.	TBD
SSAP 21R – Collateral for Loans (#2022-11)	Re-exposed	Exposed revisions clarify that pledged collateral must qualify as an admitted invested asset for a collateral loan to be admitted. The revisions require audits and the use of net equity value for valuation assessments when the pledged collateral is in the form of partnerships, limited liability companies, or joint ventures.	TBD
SSAP 61R, 62R, and 63 – Review of INT 03-02 (#2022-12)	Re-exposed	Exposed the intent to nullify INT 03-02, as it is inconsistent with SSAP 25.	December 31, 2023
SSAP 9 and 101 – Inflation Reduction Act – Corporate Alternative Minimum Tax (#INT 22-03)	Exposed	This INT addresses fourth quarter 2022 and interim 2023 reporting. It requires reporting when reasonable estimates can be made. It provides some subsequent events exceptions regarding the CAMT, to allow estimates to be updated as information becomes available.	TBD

Issue/ Reference #	Status	Action Taken/Discussion	Proposed Effective Date
SSAP 93 – Low-Income Housing Tax Property Credits (#2022-14)	Directed	Directed NAIC staff to proceed with drafting revised accounting guidance and a related issue paper for both SSAP 93—Low-Income Housing Tax Credit Property Investments and SSAP 94R—Transferable and Non-Transferable State Tax Credits. Revisions will consider final Financial Accounting Standards Board (FASB) guidance on tax equity investments and interested party feedback. Working Group directed NAIC staff to proceed with drafting revised statutory accounting guidance and a related issue paper to expand the guidance in SSAP 93 for tax credits, as well as to draft revisions to SSAP 94—Transferable and Non-Transferable State Tax Credits for future Working Group discussion.	TBD
SSAP 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (#2022-15)	Adopted	Revisions clarify that any invested asset held by a reporting entity that is issued by an affiliated entity, or which includes the obligations of an affiliated entity is an affiliated investment.	March 22, 2023
SSAP 100R - Fair Value Measurements (#2022-16)	Adopted	Revisions adopt, with modification, Accounting Standards Update (ASU) 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sales Restrictions, with modification to reject the contractual sales restrictions disclosures.	March 22, 2023
SSAP 34 - Investment Income Due and Accrued (#2022-17)	Adopted	Revisions add and data-capture additional disclosures. Directed NAIC staff to submit a corresponding blanks proposal to the Blanks Working Group for year-end 2023.	December 31, 2023
SSAP 105R - Working Capital Finance Investments (#2022-18)	Adopted	Rejects guidance from ASU 2017-12, Derivatives and Hedging and ASU 2022-04, Disclosure of Supplier Finance Program Obligations, as the disclosures are for borrowers, not insurance entity investors.	March 22, 2023
SSAP 7 - Asset Valuation Reserve and Interest Maintenance Reserve (#2022-19)	Directed	Directed NAIC staff regarding the consideration of negative interest maintenance reserve (IMR) with an intent to work on both a 2023 solution and a long-term solution	TBD

Issue/ Reference #	Status	Action Taken/Discussion	Proposed Effective Date
SSAP 7 - Net Negative (Disallowed) IMR (INT 23-01T)	Exposed	Exposure proposes a limited-time, optional, INT to allow admittance of net negative (disallowed) IMR in the general account up to 5% of adjusted capital and surplus. The INT has restrictions on what is permitted to be captured in the net negative IMR balance eligible for admittance as well as reporting and disclosure requirements.	TBD
Review Annual Statement Instructions for Accounting Guidance (#2023-01)	Exposed	Exposed a proposed new project to review the annual and quarterly statement instructions to ensure that accounting guidance is reflected within the SSAPs.	TBD
SSAP 43R – CLO Financial Modeling (#2023-02)	Exposed	Exposed revisions to incorporate changes to add collateralized loan obligations (CLOs) to the financial modeling guidance and to clarify that CLOs are not captured as legacy securities.	TBD
SSAP 51R, 59, and 61R - New C-2 Mortality Risk Note (#2023-03)	Exposed	Exposed revisions to SSAP 51R, SSAP 59, and SSAP 61R providing new disclosures, which provide net amount at risk detail needed to support updates to the life risk-based capital (RBC) C-2 mortality risk charges. This item was exposed with a shortened comment deadline of May 5.	December 31, 2023
SSAP 101 -Corporate Alternative Minimum Tax Guidance (#2023-04)	Directed	Directed NAIC staff to continue work with industry and Working Group members on developing guidance for the reporting of the CAMT for interim Working Group discussion.	TBD
INT 20-01 - ASU 2022-06, Reference Rate Reform (Topic 848), Deferral of the Sunset Date of Topic 848 (#2023-05)	Exposed	Exposed revisions to revise the expiration date of INT 20-01 to Dec. 31, 2024.	TBD
SSAP 24 - Additional Updates on ASU 2021-10, Government Assistance (#2023-06)	Exposed	Exposed revisions to SSAP 24 to clarify rejection of ASU 2021-10, Government Assistance, and the incorporation of disclosures regarding government assistance.	TBD

Issue/ Reference #	Status	Action Taken/Discussion	Proposed Effective Date
SSAP 47, 95 and 104R - ASU 2019-08, Codification Improvements to Topic 718 and Topic 606 (#2023-07)	Exposed	Exposed revisions to adopt with modification ASU 2019-08, Compensation—Stock Compensation (Topic 718) and Revenue from Contracts with Customers (Topic 606): Codification Improvements—Share-Based Consideration Payable to a Customer. The revisions add guidance to include share-based consideration payable to customers.	TBD
Appendix D - ASU 2019-07, Codification Updates to SEC Sections (#2023-08)	Exposed	Expose revisions to reject ASU 2019-07—Codification Updates to SEC Sections: Amendments to SEC Paragraphs Pursuant to SEC Final Rule Releases No. 33-10532, Disclosure Update and Simplification, and Nos. 33-10231 and 33-10442, Investment Company Reporting Modernization, and Miscellaneous Updates as not applicable to statutory accounting.	TBD
Appendix D - ASU 2020-09—Amendments to SEC Paragraphs Pursuant to SEC Release No. 33-10762—Debt (Topic 470) (#2023-09)	Exposed	Exposed revisions to reject ASU 2020-09, Amendments to SEC Paragraphs Pursuant to SEC Release No. 33-10762—Debt (Topic 470) as not applicable to statutory accounting.	TBD
SSAP 50, 51R, 52, 56, 71, and 85 - ASU 2022-05, Transition for Sold Contracts (#2023-10)	Exposed	Exposed revisions to reject ASU 2022-05, Transition for Sold Contracts as not applicable for statutory accounting	TBD
Editorial and Maintenance Update (#2023-11EP)	Exposed	Exposed editorial revisions. This item was exposed with a shortened comment deadline of May 5.	TBD

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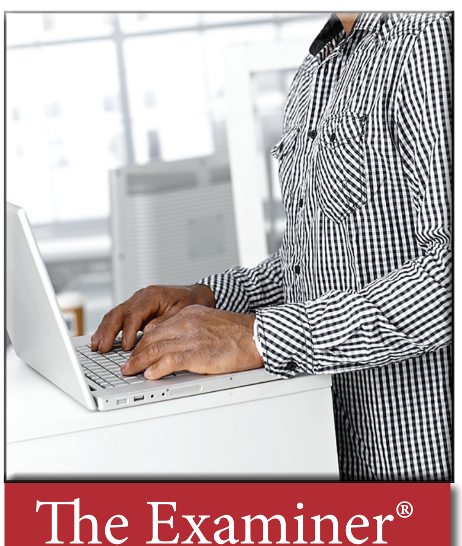

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