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You can earn **2 CRE credits** for each of the 4 quarterly issues by taking a simple, online test after reading each issue. There will be a total of 9-20 questions depending on the number of articles in the issue. The passing grade is 66%. To take the test, read all of the articles in the issue. Go to the Members section of the SOFE website to locate the online test. This is a password-protected area of the website, and you will need your username and password to access it. If you experience any difficulty logging into the Members section, please contact **sofe@sofe.org**.

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CRE Reading Program Questions

All quizzes MUST be taken online.

*Questions will be **available online Monday, October 1, 2018.***

Are Insurance Regulators Effectively Testing Liquidity Risks?

Multiple Choice Questions — Submit Answers Online

1. According to the article, a key factor to consider in understanding and assessing the company's liquidity position is which of the following?
   a. Market conduct reports
   b. Results of compliance testing
   c. Stressed scenarios
   d. All of the above

2. When should examiners begin identifying and assessing liquidity risks?
   a. Early in the examination process
   b. During Phase 3 when gaining an understanding of the controls in place
   c. During Phase 5 when performing substantive testing of investments
   d. Examiners do not need to assess liquidity risks since they are the responsibility of the actuaries and/or investment specialist

3. What Section of ORSA should include capital and liquidity risks?
   a. Executive Summary
   b. Section I
   c. Section II
   d. Section III

4. According to the Z-Score, what is one of the leading indicators of insolvency?
   a. Earnings before interest and taxes
   b. Working capital
   c. Total Assets
   d. Risk based capital

5. Which of the following should be involved in various aspects of liquidity management?
   a. Board of Directors
   b. Senior Management
   c. Executive Committees
   d. All of the above

With Several References to Avrahami, Taxpayer Loses in Reserve Mechanical Corp. Micro-Captive Case

Multiple Choice/True or False Questions — Submit Answers Online

1. Following the creation of the Reserve Captive, the ultimate individual owners, canceled their insurance from third-party commercial carriers immediately.

   a. True
   b. False

2. The court's ruling indicated all of the following related to Reserve and the reinsurance pool as the support for determining the transaction(s) is not insurance, except:

   a. There was no evidence to indicate premiums were actuarially determined.
   b. There was no legally executed agreement between the parties.
   c. The number of insureds and independent risk exposure was insufficient to distribute risk.
   d. Reinsurance flow or funds and premium amounts were not at arm's length.

3. Which of the following is not a factor indicating a captive that acts as a "bona fide" insurance company?

   a. Actuarially determined premiums
   b. Payment of claim
   c. Annual premium serving as a surplus accumulation
   d. Financial capacity to meet obligations

4. The benefit for a captive under Section 501(c)(15) and/or Section 831(b) is that the captive is either exempt from tax or is taxed on investment income only.

   a. True
   b. False

5. According to the authors, Captives involved in a risk pooling arrangement should ensure all of the following related to the transaction, except:

   a. Partner is licensed as an insurer.
   b. Partner has valid business purpose.
   c. Partner operates as an insurance entity.
   d. Partner is not formed merely as a means to meet risk-distribution.

Reserving Issues for Bail Bond Insurers

Multiple Choice/True or False Questions — Submit Answers Online

1. Remissions in the Bail Bond industry is like subrogation in other P&C industries.

   a. True
   b. False

2. The build-up Fund is specific to each agent of the surety insurer.

   a. True
   b. False

3. The bulk of losses are paid by the Bail Bond Insurer.

   a. True
   b. False

4. The bulk of the premium stays with the insurer's agent as commissions.

   a. True
   b. False

5. Which answer below best describes the insurers contract?

   a. It is a two-party agreement between and insurance Company and the courts.

   b. It is a three-party agreement between the Insurer, agent, and courts.

   c. It is an agreement where the insurer pays all losses related to the contract.

   d. It is a two-party agreement between the insurance Company and Bail Bond agent.

Making Your Risk Assessment Count

True or False Questions — Submit Answers Online

1. When evaluating regional risks, like calamities and their fiscal impact, newspapers may not be a reliable source of information.

   a. True
   b. False

2. As a best practice, examiners should obtain the Company's auditor's work papers before the end of the planning phase.

   a. True
   b. False

3. CPAs seldom have the depth of experience that an examiner has in identifying potential insurance risks.

   a. True
   b. False

4. An auditor's long term familiarity with a Company can lead to complacency.

   a. True
   b. False

5. Auditors and examiners may find it efficient to perform substantive procedures without linking them to material risks.

   a. True
   b. False

PwC NAIC Newsletter - NAIC Summer 2018 National Meeting

True or False Questions — Submit Answers Online

1. The Statutory Accounting Principles Working Group adopted revisions to SSAP 41R (Surplus Notes) to disallow capital treatment for surplus notes which are linked to other products that are not subordinate.

   a. True
   b. False

2. The Blanks Working Group adopted a proposal to eliminate the fraternal reporting blank and combine the reporting of life and fraternal companies into the life reporting blank.

   a. True
   b. False

3. The Group Capital Calculation Working Group agreed to a request to exempt health entities from the group capital calculation.

   a. True
   b. False

4. The Risk-Focused Surveillance Working Group's recommended revisions to reduce redundancies in the solvency monitoring process include a new Exhibit D (Planning Meeting with the Financial Analyst).

   a. True
   b. False

5. The NAIC/AICPA Working Group reported that all states have now adopted the revisions to the Annual Audited Financial Reports Model Law requiring companies with written premiums over $500 million annually have an internal audit function.

   a. True
   b. False

Are Insurance Regulators Effectively Testing Liquidity Risks?

By William Michael and Alex Quasnitschka

Liquidity is clearly a "critical" concern for regulators. The Financial Condition Examiners Handbook ("Handbook") provides clear guidance regarding the importance of identifying and assessing liquidity risks. For example, liquidity is one of the nine branded risk classifications, and more recently, the National Association of Insurance Commissioners ("NAIC") provided a listing of critical risk categories which cover some of the most common solvency risks, and liquidity was one of the 10 categories identified. Liquidity is also affected by other critical risk categories such as Capital Management, Appropriateness of Investment Portfolio and Strategy, and Underwriting and Pricing Strategy/ Quality, among others. While these are areas traditionally associated with the "left side of the balance sheet" (i.e., assets), the examination team should also focus on the "right side" addressing reserve adequacy and Asset Liability Matching ("ALM") processes. In addition, there are several references to liquidity in the NAIC's Solvency Risk Monitoring Alert (Spring 2018).

As such, liquidity is an important consideration for regulators when monitoring the ongoing solvency of insurance companies. With this in mind, are examiners and analysts effectively testing liquidity risks?

No matter the answer to this question, this article will provide some helpful approaches to ensure liquidity risks are adequately identified and addressed. We will also provide examples of controls that may be in place that will help ensure liquidity is properly being managed by insurance company management currently, and on a prospective basis as well.

What is Liquidity Risk? Why is it Important?

First, we will begin by providing a basic definition of liquidity. In its simplest terms, liquidity is the ability to meet obligations when due under normal and stressed conditions. Liquidity risk is the risk that the company is unable to satisfy its obligations using assets that are readily converted into cash. More specifically and as defined in the Handbook, liquidity risk is the inability to meet contractual obligations as they become due because of an inability to liquidate assets or obtain adequate funding without incurring unacceptable losses. Liquidity management is the ability of the company to generate cash when and where needed. Liquidity risk management is the process of identifying, quantifying, and mitigating liquidity risk, considering both long- and short-term liquidity.

Typical sources of liquidity are balance sheet and access to capital markets. Balance sheet liquidity is less risky given the difficulty in predicting capital markets under stress. Both balance sheet and capital markets access should be managed based on normal and stressed liquidity needs. It is important that regulators understand insurance companies' overall liquidity under stressed scenarios as well, to ensure any solvency concerns are identified. As noted above, **regulators need to consider both sides of the balance sheet and assess liquidity by evaluating both the assets and liabilities of the insurer.**

In summary, liquidity risk, particularly under stressed scenarios, could negatively impact an insurance company's financial viability and cause solvency concerns. As a result, regulators need to effectively assess liquidity risks as part of their ongoing financial solvency monitoring.

Where Do We Start on a Financial Examination?

Identifying and assessing liquidity risks should begin early in the examination process and continue throughout all phases of the exam. Some of the key procedures that should be performed are as follows:

- Discuss liquidity with the financial analysts and gain an understanding of the work they have performed along with their current assessment and any concerns. As noted previously during the NAIC 2016 Financial Condition Exam Handbook Updates & Hot Topics Webinar, meeting with the analysts is the first thing the examination team should do as part of a financial exam. Understanding the analysts' perspective on the insurer's liquidity is an important first step.

- Review the Company's responses to the Exhibit B – Examination Planning Questionnaire. Section K of this exhibit addresses liquidity and will provide the examination team with a good understanding of the company's liquidity risks. The primary purpose of this section is to gather information on an insurer's liquidity exposures under both normal and stressed scenarios. This information will provide the examination team with an understanding of the insurer's financial flexibility and its ability to manage both expected and unexpected cash demands.

- Inquire about liquidity during C-level management interviews. Understanding management's perspective and how they track and manage liquidity is an important step in evaluating liquidity risks. Discussing liquidity with senior management will provide insights regarding how much of a focus the management team has on liquidity and how aggressively they track and manage their liquidity needs.

- Review the holding company liquidity discussion in the SEC Form 10-K filing (if applicable). There may also be valuable insights regarding liquidity within the "Risk Factors" section of this key document.

It also should be noted that products and strategy impact liquidity needs as well. The examiners should gain an understanding of the cash flow characteristics of the products offered. For example, if the insurer is truly an "underwriting company" that generates cash flows from its underwriting, its liquidity position will be strengthened as a result. In addition, if a company writes long-tail lines of business, a "run on the bank" scenario will be far less likely, potentially reducing the inherent risk level for liquidity problems. Many long tail property and casualty lines do not have immediate cash payments regardless of the severity of the stress.

In addition, examiners should review combined ratio trends to determine if the loss ratios are generally stable or if there has been significant fluctuations in recent years. Typical insurance risk, like poor underwriting and adverse reserve development, can reduce cash flow profits as well as accrual basis profits. New products can increase risk and deserve more scrutiny, if material. Also, concentration risk and the insurer's overall exposure to catastrophes are important factors to consider as well because if a company has a significant amount of business concentrated in a single geographical area, they could be susceptible to significant losses in the event of a catastrophe which could negatively impact its liquidity position. True underwriting companies tend to have lower liquidity risk, so understanding the company's underwriting controls and obtaining evidence that the company maintains a conservative underwriting strategy are important steps in assessing liquidity risks.

Utilizing ORSA to Assess Liquidity Risk

Another important step that should be performed early in the examination process is reviewing the ORSA Summary Report "("the ORSA"), if the company meets the thresholds and is required to file one. ORSA reports are an important tool for regulators to utilize while identifying and assessing liquidity risks as demonstrated in the following key excerpts from Section 3 of the NAIC ORSA Guidance Manual:

- Definition of Solvency – Describe how the insurer defines solvency for the purpose of determining **risk capital** and **liquidity requirements**
- Risks modeled – Credit, market, **liquidity**, insurance, operational
- Assessment of group-wide capital adequacy should also consider….. **the effect of liquidity risk**, or calls on the insurer's capital position, due to micro-economic factors (i.e. internal operational) and/or macro-economic factors (i.e. economic shifts)[1]

  In general, Section 3 of ORSA should include both capital and liquidity considerations. A key factor to consider in understanding and assessing the company's liquidity position is the consideration of stressed scenarios. Understanding the impact of stressed scenarios for significant risks, including liquidity, is a requirement of the ORSA guidance and provides helpful insights to regulators regarding the company's overall solvency. Traditional insurance risk has been reviewed using ALM, and insurance payout patterns have been modeled effectively by actuaries for years. Investment liquidity concepts, like duration, have been built into most existing models. However, ORSA requires liquidity analysis under stress which should provide more insight than traditional analysis.

[1] NAIC OWN RISK AND SOLVENCY ASSESSMENT (ORSA) GUIDANCE MANUAL – as of July 2014, pages 9-10 (bold text added for emphasis)

Regulators should understand insurers' sources of liquidity and the draws on liquidity in both normal and stressed scenarios. There may be some scenarios where a liquidity shortfall is identified. In these situations, regulators will need to better understand the likelihood of the stressed scenario and if management should be required to address the potential shortfall. In summary, the ORSA is an extremely valuable tool for regulators to assist with assessing an insurance company's liquidity risks.

Z-Score Analysis

For health companies, examiners should typically review holding company liquidity using working capital and GAAP. Examiners should also consider the Affordable Care Act ("ACA") impact of the 3R's; risk corridors, risk adjustment, and reinsurance. At a high level, these three programs help protect health insurers against unpredictable losses or unmanageable risk selection, as well as keep consumers premiums from spiraling out of control in the early years of the ACA's coverage provisions. Start-ups tend to be inherently risky, and overreliance on government payables is often an issue. Examiners also should consider the percentage of earnings paid to shareholders.

An alternative to traditional sources of liquidity analysis is to use the Z-Score, especially when looking at liquidity at the holding company level. This powerful tool can be helpful to examiners as solvency risks may increase due to ACA requirements as the Z-Score focuses on liquidity risk which could be a problem **before** RBC Action Levels are triggered. The Z-Score is a way to measure and monitor financial performance by analyzing specific financial ratios for a given company. Developed as a bankruptcy prediction model in the 1960's, it is widely used by banks and consultants (including Risk & Regulatory Consulting ("RRC")) to evaluate companies and perform objective financial analyses.

Ed Altman, the developer of the Z-Score, studied 22 financial ratios and found that working capital is, in fact, one of the leading indicators of insolvency. Working capital, defined as current assets less current liabilities, is the key piece of information needed to use this tool. Think of working capital like the balance you have in your checkbook; should the need arise to pay unexpected bills, you have the funds readily available in your checking account and can withdraw with no penalty (i.e., these funds are short-term assets). You could have a considerable amount of money in an investment portfolio or 401 (K) account, but you might incur penalties in order to readily convert these investments to cash to pay bills. Historically, when companies experience financial difficulties, working capital will decline more quickly than total assets or capital and surplus. For health companies, as the liabilities are short-tail in nature, as opposed to Life and P&C companies being more mid- or long-term, working capital is the primary source to pay policyholder obligations or any other bills.

In addition to working capital, the Z-Score also puts a heavy weight on the "earnings before interest and taxes" ("EBIT")/total assets. This calculation is also commonly referred to as Return on Assets ("ROA"). ROA measures the basic profitability of the company in relation to its assets. Ed Altman's study proved that decreases in ROA are also highly correlated with insolvency. It is important to note that both working capital and ROA, the two most critical metrics in the Z-Score, do not currently receive much scrutiny by insurance regulators. This is why we believe the Z-Score can provide significant additional insight to the regulatory process.

The Z-Score has two additional components: retained equity/total assets and net worth/total liabilities. Both of these metrics are traditional balance sheet strength measures which we believe are similar to the RBC approach. The Z-Score model is as follows:

Z-Score Classification Model

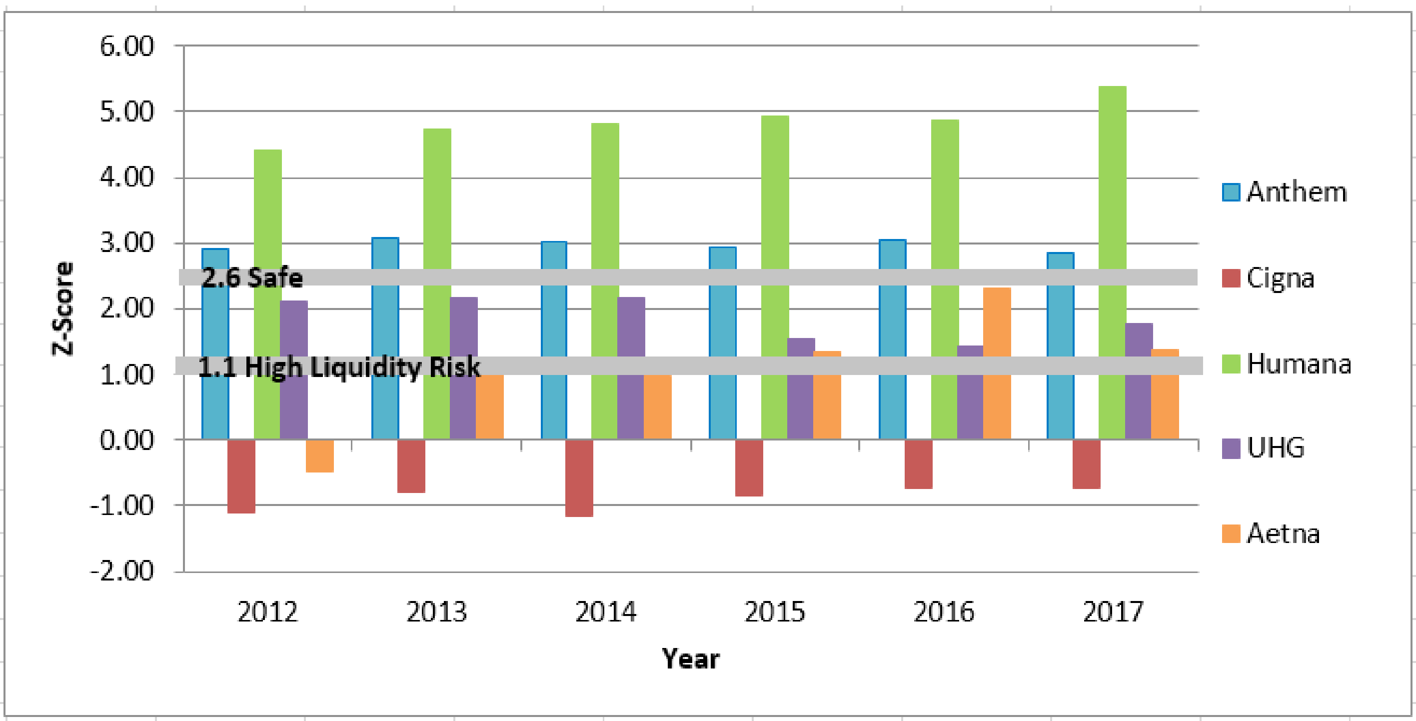
	Description		Coefficient	
1)	Working Capital / Total Assets	x	6.56	=
2)	Retained Equity / Total Assets	x	3.26	=
3)	EBIT / Total assets	x	6.72	=
4)	Net Worth (Retained Equity) / Total Liabilities	x	1.05	=
				Z-Score

One of the great benefits to using this tool is the ability to relate the total score to the following benchmarks. The company also can be compared quickly to itself, and a positive or negative trend can be noted. Per Ed Altman, historical benchmarks for the following industries are:

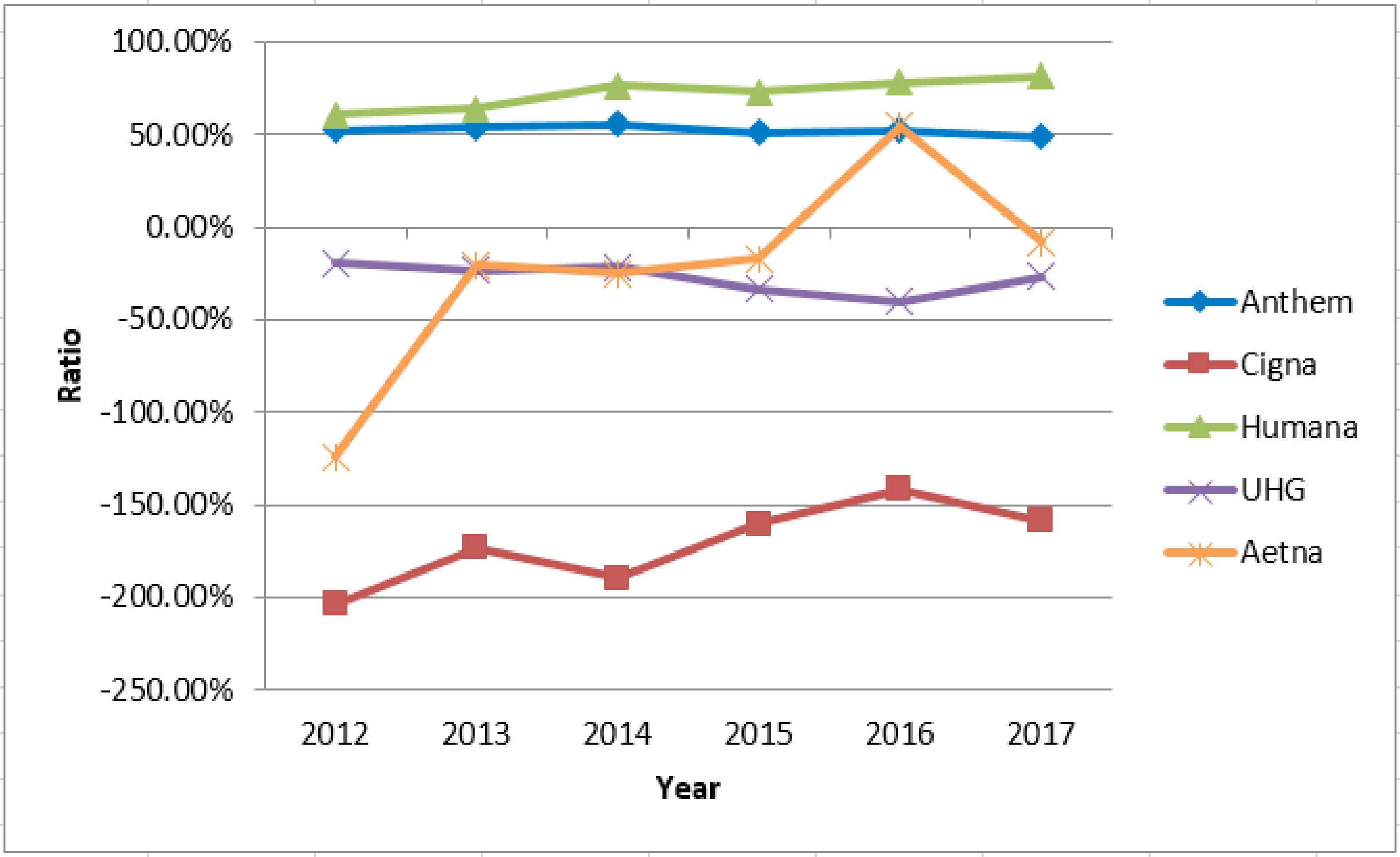
	Safe if greater than	High Bankruptcy if less than
Distribution Companies	2.2	1.0
Auto Dealers	2.0	1.0
Service Organizations	2.6	1.1
Manufacturing	2.6	1.1
A&H Companies	2.6	1.1

The above benchmarks are based on Altman's original study (which focused on manufacturing companies) and the work done by RRC and its predecessor firms. In general, the more volatility an industry has in its earnings (e.g., ROA), the higher the safe range needs to be. The ability to lose money quickly requires a stronger balance sheet. The ACA is a game changing event for the health industry, and strong balance sheets (i.e. strong liquidity position) greatly mitigate solvency risk created by the uncertainty of what will happen to traditional books of business and the related cash flow.

We calculated the Z-Score for 5 major publicly traded health companies with financial data obtained from SEC filings (e.g., 10-K's) as these financials are shown on a classified basis—i.e., short- and long-term assets and liabilities are broken out.



It's important to note the safe benchmark of 2.6 and the high bankruptcy benchmark of 1.1 when reviewing this graph. It is also extremely important and productive to review the trend of each company. Note the ability of the Z-Score to relate these companies to one another.



As seen in the chart below, working capital is a significant driver of the Z-Score. Companies with higher working capital to surplus ratios also are the companies with higher Z-Scores. As you can see, the working capital of the most disciplined companies is carefully managed within a tight range to its capital and surplus.

Note the almost direct correlation between Working Capital and Z-Score evidencing the importance of healthcare companies needing to be more liquid than Life and P&C companies due to the shorter-term nature of their liabilities. While the NAIC's primary tool for regulating companies is RBC, for health entities the Z-Score can be used to effectively analyze holding companies and legal entities for liquidity risk (where a classified balance sheet is available in public financial filings).

Identify Internal Controls and Perform Testing

Given the importance of liquidity with regards to, among other things, the solvency of a company, the examination team should gain an understanding of liquidity management within the corporate governance component of the company. Collectively, the Board of Directors (the "Board"), Senior Management, and various Executive Committees should be involved in various aspects around liquidity management, including understanding the nature of liquidity risk and developing a process of identifying, measuring, monitoring, and controlling liquidity risk. The examination team can review Board and relevant Committee minutes, as well as corresponding meeting packets to gain an understanding of how each of these groups identifies, assesses, and manages liquidity risk. These groups should actively be involved in overseeing the establishment and approval of liquidity strategies, policies and procedures, and the overall establishment and approval of liquidity management at the Company.

The examiners should observe evidence that executive lines of authority and responsibility have been established regarding liquidity risk management. These areas will most likely be evident during the C-Level management interviews and any related support requested as a result of the interviews. Through the C-Level interview process, the examination team should also be able to gain an understanding as to whether management is ensuring liquidity risk tolerance limits are established, both quantitatively and qualitatively, and communicated in a manner that allows all levels of management to clearly understand the tradeoff between maintaining liquidity risk versus gaining short-term profits. In the event of stressed scenarios, the company should have some type of contingency funding plan in place.

In some instances, the company may not have formalized the control; for example, there may not be a unique control identifier and the control may not be included in a documented walk-through. A common reason for this is that the process around liquidity management contains numerous touch points discussed by management with the Board. The examination team should review Board minutes and corresponding Board materials to determine whether liquidity risks and mitigating controls are being discussed between management and the Board under both stressed and non-stressed scenarios.

Once the examination team has evaluated liquidity management at the Board and management levels (i.e., over-arching), a deeper dive can then be made into the liquidity management strategies at various company business unit/department levels such as Investments and Actuarial. In-turn, these various departments should be working directly with the Enterprise Risk Management Committee ("ERMC"), or similar committee, to ensure mitigation strategies around liquidity risk identification and mitigation are being implemented.

As a best practice, a company's ERMC should include members of senior management from all key business units, and preferably, be led by the Chief Risk Officer ("CRO") or someone of similar title and responsibilities. Again, while we initially think of liquidity being on the left side of the balance sheet (i.e., as an asset), we must also focus on the right side of the balance sheet taking into account ALM and cash flow testing measures. The business unit heads should be working with the ERMC in developing risk identification tools, as well as the design and implementation of effective risk mitigation strategies. Once developed, the ERMC should ensure that the Board is approving these strategies, policies and procedures (i.e., internal controls), and confirm that they are being executed in an appropriate fashion.

Another key function of a well-structured ERMC is to oversee the development and implementation of appropriate risk measurement and reporting systems, liquidity buffers, and any contingent funding plans should they exist. Ideally, the examination team, through meeting with senior management, and if necessary at larger companies, meeting with business unit managers, should see evidence and support that an effective internal control structure has been put in place. Department leaders, through meetings with the ERMC, should have defined internal controls in place around liquidity risk, again, both from an asset *and* liability perspective. From here, these controls should be pushed down to managers within the various departments to ensure they are being implemented accordingly.

As part of the C-Level interview process, the examination team should be able to gain an understanding of how the various business unit leaders interact with regards to developing and modifying testing of liquidity plans under **stressed** scenarios. In well-developed stress testing, the examination team should see input and involvement from the investments and actuarial functions to ensure, given certain stressed scenarios, that assets can readily be converted to cash to pay for current and future obligations, as well as determine whether the company's stated reserves would be adequate under said stressed scenarios (e.g., ALM). From both the investments side and actuarial side, the examination team should expect to see an integration between liquidity costs, benefits, and risk into internal pricing. In some cases, lack of liquidity in stressed scenarios could be due to inadequate pricing. As such, there may be a need to discuss this area with the Underwriting department. If needed, management may need to modify its plans if it feels liquidity could be an issue during a stressed scenario. In any event, these plans should be discussed at the Board meetings. There should be regular monitoring of liquidity risk for all entities across a holding company group.

When conducting Group examinations, the risk may not always be at the parent company level (i.e., the parent does not have adequate funds to support affiliates if need-be). The reverse scenario could be that an affiliate's lack of liquidity could lead to draining of the parent's capital to support its ongoing business. Examiners need to be aware of both potential scenarios.

Through the C-Level management interviews, the examination team should gain an understanding of how management is assessing liquidity objectives. For example, with regards to risk appetite, is management complying with its quantitative and qualitative guidelines set to manage risk tolerance levels? The examination team should determine whether management is aligning incoming and outgoing cash flows in order to maintain liquidity levels within ranges or targets approved by the company's governance structure. This is an area the ERMC should be actively monitoring. During the normal course of business, as well as under stressed scenarios, both internal and external, management should be maintaining sufficient sources of **liquid** funds to meet current and future obligations. Management should be modeling a range of plausible scenarios, stressed and even reverse-stressed. Ask yourself this question: "if a bond cannot not readily be converted to cash without taking a loss or penalty, is that bond truly liquid?" In most cases, that answer is "NO." This was a hard lesson learned during the financial crisis of 2008 and

2009. On the surface, it appeared as though the investment banks were well capitalized and liquid, despite large portfolios of CMBS and RMBS securities. Once these bonds were unwound, and it was determined the assets (i.e., the mortgages) backing these bonds would not be paid, the bonds were essentially worthless.

With regards to short-term liquidity internal controls and functions, if needed, the examination team should be reaching out to investment and actuarial subject matter experts to ensure liquidity is sufficiently monitored and reviewed. The company's cash management function should provide insight to the examination team regarding how liquidity is monitored and reviewed. The cash management function should incorporate individuals from various business units, including, but not limited to; Treasury, Financial Reporting, Investments, and Actuarial. In many cases, ratios should be evident that evaluate the sufficiency of liquidity and their connection to assessed risks (e.g., low, moderate, elevated, or high). Acceptable ratios should be defined along with action plans to be taken in the event ratios are not being met.

In order for the examination team to gain an understanding of a company's long-term liquidity internal controls and functions, management should demonstrate it has identified and assessed various triggers and/or targets. This can be done through stress testing using various inputs. The examination team should determine, most-likely through conducting C-Level management interviews and reviewing related support, whether the analyses are adjusted to reflect changes in company operations and the economic environment. The examination team should also identify the company's processes in place for reviewing and evaluating stress testing results. They should determine who is performing the stress testing, as well as to whom and how frequently the results are being presented. In some cases, these results may be presented in quarterly Board packages or dashboards.

In the event a liquidity breach does occur, the examination team should determine if the company has a documented plan or "playbook" in place to address such an event. This plan should include escalation procedures including meetings with various governance and risk committees and other members of senior management in order to (1) assess contingent funding capacity, (2) execute internal asset transfers, and/or (3) sell assets in the market to generate the needed liquidity. In the event a breach is not remediated by management, the examination team should inquire if plans for communication exist between management with key external groups including regulators, rating agencies, customers, creditors, and other key stakeholders.

Summary

Liquidity is a "critical" risk that could lead to significant solvency concerns. As a result, liquidity risks should be identified and evaluated during risk-focused financial examinations. It is important to remember that examiners need to consider both sides of the balance sheet when evaluating an insurer's liquidity risks. There are various resources and tools available to perform testing and evaluate liquidity risks, including the ORSA and Z-Score tools. A key factor in evaluating insurers' liquidity risks is the consideration of stressed scenarios and understanding any potential liquidity shortfalls. We believe consideration of liquidity risks and implementation of the guidance described above will help contribute to effective financial examinations, which, in turn, will add to the overall effectiveness of the regulatory surveillance cycle and provide insurance departments with a better understanding of the insurance companies' risk profiles.

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Bill has over 20 years of experience providing business advisory consulting services to clients within the insurance industry, including 12 years working on risk-focused examinations. Bill has served as the examiner-in-charge on several financial examinations, including coordinated examinations of large, complex, multi-state insurance companies. He also provides training to State clients on variety of topics such as corporate governance, prospective risks, and other critical issues.

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Alex has over 15 years of experience in the regulatory insurance industry. As an Examiner-In-Charge, Alex leads statutory examinations of insurance companies on behalf of state insurance departments. Over the past several years, Alex has participated in various liquidity risk presentations, including at SOFE CDS and for state clients.

With Several References to Avrahami, Taxpayer Loses in Reserve Mechanical Corp. Micro-Captive Case

By Carrie Small and Tim Kramer

This article is an update and continuation to the article "Micro-captive Arrangement Deemed Not to Be Insurance; Taxpayer Loses in Avrahami Case" by Carrie Small, as published in the Winter 2017 Issue of The Examiner.

In the latest micro-captive case to make it to trial, the U.S. Tax Court backed the Internal Revenue Service (IRS) by holding that a micro-captive was not an insurance company as defined by section 816(a),[1] did not qualify for tax-exempt treatment of income under section 501(c)(15), and had an invalid election under section 953(d) to be taxed as a domestic corporation. The court also ruled that revenues received by the captive insurance company qualified as "fixed or determinable annual or periodical" income (FDAP income) and were subject to a 30 percent withholding tax under section 881(a)(1).

The Court held that the micro-captive and risk-pooling arrangement did not constitute bona fide insurance and thereby could not be respected as such.

Background

The petitioner in *Reserve Mechanical Corp. v. Commissioner*, T.C. Memo. 2018-86, (Reserve), is a captive insurance company formed in 2008 to insure certain risks of three business ventures owned by Reserve's ultimate individual owners, Norman L. Zumbaum and Cory Weikel. The most significant of these ventures was Peak Mechanical & Components, Inc. (Peak), which focused on distributing, servicing, repairing and manufacturing equipment used for underground mining and construction. In forming and operating Reserve, Zumbaum and Weikel engaged Capstone Associated Services, Ltd. (Capstone) to perform a captive feasibility study and other services relating to forming and operating a captive insurance company. Despite the formation of the captive insurance company, the entities owned by Zumbaum and Weikel maintained their insurance from third-party commercial carriers.

Reserve issued direct written insurance policies with Peak and the two other businesses as the named insureds on each policy. All of the policies showed one premium price and did not specify amounts to be paid by each of the insureds. Additionally, each policy listed PoolRe Insurance Corp. (PoolRe) as the stop loss insurer. Capstone administered PoolRe's operations and maintained its books and records. PoolRe entered into stop loss endorsements similar to those of Reserve for insurance policies that other Capstone entities issued.

In addition to the direct coverages provided by Reserve, for the tax years in issue, Reserve started participating in a quota share reinsurance policy with PoolRe where Reserve, as well as the other Capstone entities, agreed to assume coverage for a specified portion (quota share) of the risks that PoolRe had assumed. This policy was structured such that the quota share that Reserve assumed entitled Reserve to receive payments from PoolRe equal to the premiums that PoolRe was to receive from Peak.

Prior to the formation of Reserve, Peak spent approximately $39,000 and $96,000 insuring its business through third-party commercial insurers during 2006 and 2007, respectively. In 2008, 2009 and 2010, insurance premiums

[1] All section references are to the Internal Revenue Code of 1986, as amended.

paid to Peak beyond the third-party coverage Reserve continued to maintain were approximately $412,000, $448,000 and $445,000, respectively. Peak made only one claim under its direct written policy with Reserve during 2009 totaling approximately $165,000 related to the loss of a major customer. After the tax years in issue, an addendum to the claim was made for an additional $175,000.

The Court's holdings

Similar to *Avrahami v. Commissioner*, 149 T.C. No. 7 (Aug. 21, 2017), the IRS took the position that Reserve's insurance and reinsurance transactions lacked economic substance and therefore Reserve was not deemed to be an insurance company within the meaning of subchapter L of the Code. Additionally, because Reserve's predominant activity was not insurance, it could neither make the 953(d) election to be taxed as a domestic corporation nor be considered a tax-exempt insurance company within the meaning of section 501(c)(15). The Commissioner argued that Reserve's arrangements with Peak and the other insureds was not insurance. The Commissioner also determined that the quota share arrangement provided the appearance of risk distribution without actually distributing any risk, as PoolRe was not a bona fide insurance company.

Judge Kathleen M. Kerrigan confirmed that Reserve's election under section 953(d) was invalid for the tax years in issue. Because of this, Reserve should be treated as a foreign corporation, and thus would be subject to the 30 percent withholding tax on its FDAP income under section 881.

The court held that there was no true risk distribution, as the number of insureds and independent risk exposures was insufficient to distribute risk. The court further held that Reserve's quota share policies with PoolRe were not bona fide insurance agreements as the arrangements involved a circular flow of funds and premiums were not determined at arm's length. Further, the court held that there is no evidence to indicate that the premiums were actuarially determined and PoolRe's activities were not those of a bona fide insurance company.

Increased scrutiny on micro-captive arrangements

While the negative facts highlighted by the court are specific to this case, it serves as an important reminder for taxpayers to revisit the structures of their micro-captives. The concern is that micro-captives are formed to create a deduction for the related-party owner for the insurance premiums paid, while the micro-captive either is exempt from tax if qualifying as a tax-exempt insurance organization under section 501(c)(15) or pays tax only on its investment income under section 831(b). The micro-captive then builds up a surplus from the annual premium income while paying few, if any, claims.

Micro-captives that do not have similar facts to *Reserve Mechanical* or *Avrahami*, and which act as a bona fide insurance company, are paying claims, have actuarially determined premiums and are financially capable of meeting its obligations, should continue to withstand IRS scrutiny.

What constitutes insurance?

The U.S. Tax Court ultimately ruled that the Reserve's micro-captive arrangement, as well as PoolRe's risk-pooling arrangement, did not constitute bona fide insurance. While there is no true definition of insurance in either the Internal Revenue Code or the U.S. Treasury regulations, taxpayers are guided by case law in determining whether insurance exists for federal income tax purposes. To be considered insurance, an arrangement must:

- Involve risk-shifting
- Involve risk-distribution
- Involve insurance risk
- Meet commonly accepted notions of insurance

Other factors that are also considered include:

- Is the company organized, operated, and regulated as an insurance company?
- Is the insurer adequately capitalized?
- Are policies valid and binding?
- Are premiums reasonable and the result of an arm's length transaction?
- Is comparable coverage more expensive or even available?
- Are claims paid?

Generally, the micro-captive should operate as a separate risk-bearing enterprise and function no differently than a third-party insurer.

Impact of this ruling on micro-captives

There can be significant tax consequences for micro-captives that fall under a fact pattern similar to that presented in *Reserve Mechanical* or *Avrahami*. The tax benefit of qualifying as a tax-exempt insurance organization under section 501(c)(15) or a small insurance company under section 831(b) is that the captive is either exempt from tax or is taxed on investment income only (therefore not on underwriting, or premium, income). An insurance company is generally considered a tax-exempt insurance organization when gross receipts are less than $600,000 or a small insurance company when premiums are less than $2.2 million and $2.3 million for 2017 and 2018, respectively. If the captive does not fall under either limitation, underwriting income becomes taxable. However, even more importantly, the company must first be an insurance company. In *Reserve Mechanical* and *Avrahami*, it was determined that the arrangements did not constitute insurance.

In addition to ensuring that micro-captive arrangements meet the definition of insurance as discussed above, taxpayers should re-evaluate premium pricing to ensure the use of actuarial assumptions that represent the current market, and reconsider the validity of the assumptions used as compared to those used by other actuaries.

Lastly, taxpayers involved in a risk-pooling arrangement should ensure the fronting company has a valid business purpose, operates as an insurance company and is not formed merely as a mechanism to meet risk-distribution requirements. A circular flow of funds similar to the arrangement under Pool-Re may be a cause for concern as to whether or not there is true risk shifting and risk distribution.

We recommend organizations contact their tax and captive advisors to review their specific situation for potential recommendations.

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Reserving Issues for Bail Bond Insurers

By Dave Heppen and John Humphries

Bail Bond Insurance - Introduction

Bail bond insurers provide the bonds used by licensed bail agents to secure the release from jail of an accused defendant facing trial. Losses occur when a released defendant does not appear for a scheduled court date and is not recovered within a stated amount of time. Bail bond insurers, as is common in financial guaranty insurance, typically have very high expense ratios and very low loss ratios.

Despite these low loss ratios, there are challenges in reserving for losses for bail bond insurers. While these challenges at first glance appear to be unique to this atypical line of business, closer review shows that there are strong conceptual similarities to highly topical challenges facing the property and casualty (P&C) industry as a whole. This article is intended to help financial examiners and analysts understand bail bond reserving issues and their similarities to broader P&C challenges.

Bail Bond Insurance and Social Considerations

The concept of bail is inextricably linked to significant social questions related to the justice system in the United States. The future of bail bond insurance may be in doubt, as discussed in a recent article from AM Best "*Was 2017 the Tipping Point for the Bail Bonds Industry*"[1]. Prominent states are considering proposals to reduce the reliance of the justice system on cash bail.[2] The bail bond insurance industry is receiving scrutiny from the federal government, as demonstrated by a recent letter from Senator Cory Booker and Senator Sherrod Brown sent to 22 bail bond surety underwriters[3].

Nothing in the discussion that follows should be construed to represent the authors' opinion on the social issues related to bail bond insurance.

Bail Bond Insurance Terminology

From the point of view of the financial examiner or analyst, bail bond insurance is very different from typical property and casualty (P&C) insurance. Two key terms that will be discussed in this article are:

- *Build-Up Fund (BUF)* – specific to each agent issuing bonds on behalf of the surety insurer. The BUF is funded by a portion of the bail bond premium and is intended to provide the insurer with a backstop in the event of a bond forfeiture. BUF account values cannot be commingled between agents; the BUF for a particular agent is available only for losses related to bonds issued by that agent.

- *Remissions* – recovery of the defendant subsequent to bond forfeiture, enabling the bond agent to recover all or part of the forfeiture judgment previously paid.

With this terminology in mind, we now turn to key challenges in bail bond reserving and discuss parallels to these challenges in the broader P&C industry.

Reserving Challenge #1: Low Loss Volume

Bail bond insurers typically experience low loss ratios, often 10-20% or even lower. This is due to the fact that the bail agents retain the vast majority of the premium in the form of commissions. The bail agent is responsible for paying losses in the event of bond forfeiture, though ultimate responsibility lies with the insurer. As a result, bail agents typically pay the bulk of the losses. The bail bond insurer pays only those losses that the bail agent cannot pay.

From a reserving perspective, low loss volume generally leads to significant uncertainty in projecting ultimate losses. Questions that the examiner and analyst can consider asking include:

- To what extent is the bail bond insurer's loss history considered credible for loss reserving?
- Is industry data considered in the projections of reserves, and if so, what is the source of that industry data?
- Are projections based only on the bond insurer's net losses, or is consideration given to losses paid by the bail agents?

Analogous P&C Industry Reserving Challenge: Excess of Loss Reinsurance Reserving

Excess of loss reinsurers often face similar challenges when reserving for losses. Just as bail agents pay the majority of bail bond losses, so too do primary insurers generally pay the majority of losses in excess of loss reinsurance arrangements. The excess of loss reinsurer is therefore faced with analogous questions as the bail bond reinsurer in determining its reserves:

- To what extent is the past history of large losses considered credible for loss reserving?
- Is industry data considered in the projections of reserves, and if so, what is the source of that industry data?
- Are projections based only on large losses or is consideration given to losses below the attachment point of the excess of loss reinsurance agents?

This illustrates that fundamental questions regarding loss reserve projections for bail bond insurance are not at all unique to that class of business. Excess of loss reinsurance is just one instance of countless examples of such challenges that insurers and actuaries face throughout the P&C industry.

Reserving Challenge #2: Treatment of Remissions

A bail bond insurer's losses can be impacted by remissions, recoveries subsequent to loss payment. This leads to another fundamental question related to reserving for bail bond insurers. Questions that the examiner and analyst can consider asking include:

- Is the loss reserve analysis conducted gross or net of remissions?
- Is one approach viewed as superior to the other, and, if so, why?
- What impact do remissions have on the results of the reserve analysis?

Analogous P&C Industry Reserving Challenge: Treatment of Subrogation

Subrogation recoveries play an important role in reserving for many more traditional P&C coverages such as auto. In such cases, similar questions arise:

- Is the loss reserve analysis conducted gross or net of subrogation?
- Is one approach viewed as superior to the other, and, if so, why?
- What impact does subrogation have on the results of the reserve analysis?

This is another instance in which something that at first glance appears to be unfamiliar and unique, remissions in bail bond insurance, is actually quite similar from a loss reserving standpoint to a common dynamic of P&C reserving, namely subrogation.

Reserving Challenge #3: Treatment of Build-Up Funds

Build-up funds are available to bail bond insurers to absorb all or part of losses related to particular bail agents. However, build-up funds related to one bail agent cannot be used to absorb losses related to another bail agent. Questions that the examiner and analyst can consider asking include:

- Is the loss reserve analysis conducted gross or net of BUF recoveries?
- If gross, are losses projected at the agent level, such that the available BUF funds for an agent can be compared to the estimated losses for that agent?
- What impact does the BUF have on the results of the reserve analysis?

Analogous P&C Industry Reserving Challenge: Treatment of Collateral in Large Deductible Reserving

At first glance, the BUF may seem to present a unique challenge to bail bond reserving. However, a similar situation can be found with respect collateral associated with large deductibles. As with the BUF, any collateral required by the insurer for particular insureds cannot be commingled. And as with bail bond insurance, the insured is first in line to pay losses within the deductible, though the insurer bears ultimate responsibility. The analogy in this case is not complete, as deductibles are generally expected to be fully collateralized, while the BUF is not expected to absorb 100% of losses. Despite this difference, key questions associated with collateral mirror questions associated with the BUF:

- Is the loss reserve analysis conducted gross or net of deductible losses?
- Is the loss reserve analysis conducted at the account level, such that recoverables in the deductible layer can be compared to available collateral account by account?
- What is the approach for determining the potential for unrecoverable losses in the deductible layer due to insufficient collateral?
- What is the magnitude of anticipated deductible recoveries, and how does that compare to the available collateral?

This is a third example of a challenge in bail bond insurance reserving that is similar in many ways to challenges that impact the P&C industry as a whole.

Conclusion

The Bail Bond industry is unique in the issues and risks that must be faced in financial examinations. In addition to ongoing debate related to societal issues, there are reserving challenges with very low loss ratios, low claim volume, build up accounts and remissions. Fortunately, there are analogous reserving challenges in other lines of business and techniques to help address these challenges[4].

Data Source Citations

[1] See http://news.ambest.com/presscontent.aspx?refnum=26680&altsrc=9, June 7, 2018

[2] See Latest Casualty of Government Regulation: Bail-Bond Insurance, Wall Street Journal, June 7, 2018

[3] See https://www.booker.senate.gov/?p=press_release&id=837, August 7, 2018

[4] The authors would like to acknowledge and thank Mr. Ben Silberstein, FCA, MAAA, ACAS and Ms. Abby Ouimet, FCAS, MAAA, both of AJA Risk Management Consultants, Inc., for contributing to this article through various discussions on bail bond reserving.

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Making Your Risk Assessment Count

By Lewis D. Bivona, Jr.

While examiners are quite familiar with current risks that plague insurers, we are not always on top of what emerging or pre-emergent risks are in the marketplace. Considering your next examination company's risk is the most critical task you can undertake, ask the NAIC! You can't assume that someone else has done it, say the company's auditors, you must do it yourself. You might ask why, but the answer is clear. CPAs may read risk alerts and other news article to develop their risk planning, but they will very likely never have the depth of experience that an examiner has when it comes to tell tale signs of a potential emerging insurance risk or risks!

So, pragmatically, where do you start to evaluate risks? While no approach is the same, all good risk assessments should consider multiple data sources. Newspapers, while not totally trustworthy for lack of political bias, are often great at covering calamities and their financial impact on a regional basis. Concerned about flood risks, wild fire exposures automobile theft rates? They are all covered by most regional/national news outlets.

What risks are noted in *Best*? What do the latest trends show for the lines of business that you will be examining in your next company? The NAIC has so much data that you can readily access to do two things - access your risks and assess the risk assessors' (the internal and external auditors of the company) perspective on risks. (We'll get to that a little later in the article!)

There are numerous other web sources that are worth skimming for articles pertaining to your risks. If you have a concern about the strength of a reinsurer or what is trending in the reinsurance market, look at Global Reinsurance (globalreinsurance.com). If you have general questions about issues related to the Property & Casualty or Life & Health markets, or even specific concerns like cyber-liability or political unrest, I would suggest viewing either the *Insurance Journal* (insurancejournal.com/news/) or *Risk & Insurance* (riskandinsurance.com/) as a good starting point for salient risks. Also, don't forget the obvious, review and discuss the responsible analyst and chief analyst's workpapers with them in person. Although the NAIC constantly reminds examiners to query the people responsible for watching the insurer since the last examination it is often happening later than sooner.

Why all the homework you might ask? I'll tell you why! The AICPA Peer Review Program results in 2016 showed that more than 10% of the firms performing audits failed to comply with the guidance in AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* or AU-C Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained.* This issue was particularly acute in small to medium sized companies that believed that they could perform a quality audit without considering the clients risks; it is also important to note that these auditors typically audit small to medium sized insurers. That being said, even large auditors can become complacent when performing audits on their large to medium sized insurers year after year. Remember, familiarity can often compromise an audit. Skepticism is the auditors' and examiners' best friend; if you look at what could go wrong instead of what has gone right, you will always have a better audit/examination.

Remember earlier I alluded to "watching the watchers"? The best way to assess the risks that you have developed is to understand exactly what risks the Company's internal auditors defined, assessed and mitigated. Also, how did the external auditors leverage the work of the internal audit, and what measure of reliance did they assign to it? Another important issue is to ascertain whether the external auditors developed risks that the examiner felt were meaningful and tested them accordingly. Just like examiners, if auditors do not assess client risk then they will not have a basis for a good audit plan that would rule out those material risks. Another best practice, as a result of this assessment, is to obtain the auditors work papers before or at the very least close to the start of the examination planning phase.

Performing substantive procedures without linking them to a material risk is wasted time, whether you are an auditor or an examiner. You could get lucky and find something, but like a good hunter, preparation and studying your intended prey's terrain and habits raises your likelihood for success. Even worse is using a standardized audit/examination program without consideration of the risk and modifications of test attributes to identify and detect those risks. For example, the insurer just replaced its claims system with a new system, most auditors would consider testing the system to the old test to ascertain that claims processing speed was the same or better but that would not be the best test in and of itself. Perhaps looking at initial processing, accuracy, and claims reprocessed coupled with insured/member/provider complaints statistics would be a better test.

Lastly, look for thoughtful risk assumptions. A start-up company might have a plethora of risks including competitive pricing, growth, unstable workforce and/or lack of experience. A large established company could still have the same risks, but it would be doubtful, perhaps reinsurance, exposure and new product/market risks. If the risk assessments you see are cookie cutter without evidence of much thought be hyper-diligent.

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Lewis (Lew) has more than 35 years of experience in the health care industry and functions as a financial examiner and health subject matter expert (SME) for InsRis. The depth of his experience includes high-level positions within HMOs, consulting and hospital care. Lew has performed financial examinations of health insurance and P&C companies throughout the United States. He also has lead audits of the Employee Retirement Income Security Act (ERISA) based health plans for employers concerned with both costs and their fiduciary responsibilities. As a regulator with the NJ Department of Health, Mr. Bivona was responsible for the financial analysis function of all 13 HMOs licensed in the state, including preparation of the HMO annual report for consumers. He was responsible for reviewing and critiquing the analysis quality of financial reviews performed by state analysts as a member of the NAIC Accreditation Team. After working as a regulator, Lew was partner in charge of the insurance practice at Withum, Smith and Brown PC, a New Jersey public accounting firm, and served as senior manager of the insurance practice at the public accounting firm of Amper, Politziner and Mattia. In that capacity he was not only responsible for the financial condition examination for various states, but was also in charge of audits of life, health and P&C companies where he regularly assessed the premium, underwriting and claims functions of all auditees.

PwC NAIC Newsletter

August 2018

The National Association of Insurance Commissioners held its Summer National Meeting in Boston. This newsletter contains information on activities that occurred in some of the committees, task forces and working groups that met there and includes subsequent conference calls through August 20. For questions or comments concerning any of the items reported, please feel free to contact us at the address given on the last page.

In this issue

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Executive Summary

- The Statutory Accounting Principles Working Group adopted INT 18-03 related to tax reform and finalized guidance on accounting for life insurance policies owned by insurers. The working group also exposed proposed accounting for hedging variable annuity contracts, life and P/C reinsurance, “regulatory invested asset transactions,” “linked” surplus notes and the statutory consideration of ASU 2017-12, Derivatives and Hedging.
- The Life RBC Working Group approved revisions to the 2018 life RBC formula to reflect the effect of tax reform, which is expected to have a material adverse effect on RBC ratios. The Investment RBC Working Group announced that a 2020 implementation of revised RBC factors for invested assets is now more likely than a 2019 effective date. The Operational Risk Subgroup restarted its discussion of a growth risk charge for life insurers.
- The Blanks Working Group adopted implementation of the private letter (PL) designation for year-end 2018 and approved new liquidity disclosures for life insurers for 2019 year-end.
- The Valuation of Securities Task Force proposed elimination of the Modified Filing Exempt process for non-modeled SSAP 43R securities as of January 1, 2019.
- The Group Capital Calculation Working Group continued development of the calculation for field testing in 2019, focusing on the treatment of captives, subordinated debt and non-regulated entities, and exposing for the first time a proposal that would scope out U.S. insurance groups that are not subject to ORSA.
- The Reinsurance Task Force received comments on the first draft of its proposed revisions to the credit for reinsurance models to reflect adoption of the U.S/EU Covered Agreement.
- The Variable Annuities Issues Working Group adopted the VA Framework to revise reserving and RBC for variable annuities, with a targeted implementation date of January 1, 2020.
- The Joint Long-Term Care Task Force heard a proposal on a multi-state rate approval system to provide better coordination among the states.
- The Financial Stability Task Force discussed documents on the scope and design element considerations of a possible liquidity stress testing framework for large life insurers.

PwC NAIC Newsletter

August 2018

All documents referenced can be found on the NAIC website naic.org.

Executive Committee and Plenary

The Executive Committee adopted three technology related fiscal impact statements, each of which are part of the NAIC State Ahead strategic plan: Enterprise Data Strategy, Governance, and Management; Enterprise Data Platform and Data Warehouse; and Dynamic Content Website. The committee discussed the purposes and goals of the proposals, key deliverables and measures of success, organizational impact, budgets, and other impacts prior to adoption of the statements, which had previously exposed for comment. The goals of the data projects are to improve the ability to provide analytics to regulators for improved consumer protection, to ensure consistency in the reporting, analysis and security of data collected by the NAIC, and create a "standardized online customer experience for state insurance regulators, consumers and industry."

Cybersecurity

Insurance Data Security Model Law adoption
The South Carolina Data Security Act was adopted in May, effective January 1, 2019, and closely mirrors the NAIC standard. Director Farmer noted that South Carolina plans to issue bulletins regarding their progress so that others can learn from their implementation. Rhode Island has introduced legislation to adopt the NAIC's model.

Joint Cybersecurity Forum
On October 10, the NAIC is sponsoring a joint forum with Stanford University on the "current cyber risk landscape and cyber threat intelligence, data and information-sharing."

Innovation and Technology Task Force

Regulatory sandbox
During its June conference call the task force discussed results of a survey in which states responded with regard to their readiness to deal with innovation and technology, noting that states reported as "ready" will be studied by the task force to help identify best practices. At its meeting in Boston, the task force approved a plan for moving forward on a number of regulatory innovative concepts: researching states' adoption of anti-rebating, non-cancellation requirements, and e-signature and how those comply with laws and regulations; confirming state insurance departments' innovation contacts and publishing them in the near term; and forming a small team of regulators to begin outlining plans for gathering and sharing information on what states and other federal and foreign regulators are doing in the innovation space.

The June meeting also included discussion of regulatory sandboxes. The Iowa Insurance Division is supportive of a regulatory sandbox and is looking to formalize the process. A platform in Des Moines titled the Global Insurance Accelerator has two annual programs to attract early innovators. One of the goals of this sandbox is not to pick "winners" and "losers" but rather to let consumers use new products in a safe, regulated environment. Commissioner Wade reported that Connecticut is piloting a regulatory sandbox entitled the InsurTech Hub.

At the Summer National Meeting, the task force heard a presentation from the UK's Financial Conduct Authority regarding its experiences and lessons learned in working with innovators and the FCA's regulatory sandbox. The FCA formed Innovate Group four years ago, which has created a regulatory sandbox for companies in the UK with innovative financial products that meet certain criteria to test their ideas and products with real consumers and close oversight. Successful innovations are then able to be licensed and to go to market. Innovate Group is working on a global sandbox, called the Global Financial Innovation Network, in hopes to create such an environment for global companies to test innovations and new products.

Big data

Predictive models
The Big Data Working Group heard a report from the Casualty Actuarial and Statistical Task Force on its progress on developing best practices for predictive models and analytics and providing guidance to states on complex predictive models for rate filings. Actuaries from five states have volunteered to draft guidance on data sources, selected model input, model building, the filed rating plan and what is included in the model. The task force hopes to have a first draft for discussion this fall.

Automated underwriting
The working group received a presentation from a representative of LIMRA on automated underwriting, which noted that 50% of companies surveyed responded that they are using some type of automated system to replicate the decisions of human underwriters, as a result of access to new data sources and technology. The working group discussed whether disclosures to consumers about automated underwriting are adequate. One regulators suggested that the working group draft a consumer alert to explain this underwriting and use of data, but no final decision was reached.

Statutory Accounting Principles Working Group

The working group met via conference call in May and at the Summer National Meeting; significant actions include the following. (Appendix A to this Newsletter summarizes all actions taken by the working group since the Spring National Meeting.)

SSAP 101, Federal Income Tax Reform (#2018-01)
The working group adopted proposed minor revisions to SSAP 101, which add footnotes and revise Q&A guidance to reflect certain changes resulting from federal tax reform. More substantive revisions to the examples in the Q&A will be completed as a separate project of the working group.

There was no discussion this spring or summer by the working group of the SSAP 101 assessment of reversal patterns of deferred tax items under the new tax act; the regulators had asked for comments from interested parties.

INT 18-03 – Additional Elements under the Tax Cuts and Jobs Act (#2018-15) – The working group adopted this INT as final which addresses three specific topics as follows:

- Repatriation Transition Tax – The payable related to the RTT shall be recognized as a current year tax expense, regardless of whether the entity elects to make installment payments of the amount owed. Disclosures are also required.

- Alternative Minimum Tax Credit – The AMT credit may be reported as either a current year recoverable or a deferred tax asset. A detailed new rollforward was also adopted, which will disclose the beginning balance, amounts recovered, adjustments, ending balance, any amount reduced for sequestration, any nonadmittance elected by the reporting entity (prior to application of DTA admittance limitations), and the ending balance (after sequestration and elected nonadmittance).

- Global Intangible Low-Taxed Income Tax – Reporting entities shall not recognize deferred GILTI tax for basis differences in foreign entities. However, reporting entities are permitted to recognize deferred taxes for basis differences expected to reverse as GILTI in future years if they have recognized under U.S. GAAP deferred taxes for basis differences expected to reverse as GILTI, with appropriate disclosure.

This INT is expected to be nullified in 2026, after the final RTT payment; however, it may be revised prior to nullification if the FASB issues guidance related to the GILTI tax.

SSAP 86 - ASU 2017-12, Derivatives and Hedging (#2017-33) – At the Summer National Meeting, the working group discussed industry comments on draft Issue Paper 15X, which proposes adoption of much of GAAP standard that is designed to simplify the application of hedge accounting. Industry is suggesting that the statutory adoption be bifurcated into two workstreams: nonsubstantive changes to simplify hedge accounting to be effective January 1, 2019 and other more complex changes implemented later with the assistance from industry experts.

Three elements of the ASU 2017-12 changes proposed by industry to be adopted effective January 1, 2019 are as follows:

1. Allow companies to perform subsequent assessments of hedge effectiveness qualitatively if certain conditions are met,

2. Allow companies more time to perform the initial quantitative hedge effectiveness assessment, and

3. Clarify that companies may apply the "critical terms match" method for a group of forecasted transactions if the transactions occur and the derivatives mature within the same 31-day period or fiscal month, and the other requirements for applying the critical terms match method are satisfied.

The working group agreed to this bifurcated approach; subsequent to the meeting in Boston the working group exposed a Form A with the proposed non-substantive revisions discussed above, and a provision for early adoption for year-end 2018. Comments have an expedited due date of September 14.

SSAP 86 – Special accounting treatment for derivatives hedging VA contracts (#2016-03) – At the Summer National Meeting, the working group exposed for comment draft SSAP 108, Derivatives Hedging Variable Annuity Guarantees, and a revised issue paper. Significant changes from the last exposure in March include the following:

- Removal of an alternative method (using Rho) to calculate the deferred hedging assets and liabilities. Use of the fair value of the hedged item (AG 43 reserve) would be the only prescribed method.

- Addition of a requirement that, upon request of the domiciliary regulator, companies would provide estimates of what RBC would be if the special derivative accounting was not used. SSAP 108 retains the requirement to segregate from unassigned funds to special surplus an amount equal to the net amount from all hedging strategies/programs for variable annuities.

- Revisions proposed by the ACLI related to guidance on assessing hedge effectiveness

- Removal of the previously proposed transition provisions; insurers will instead work with their domiciliary regulators on changing from permitted or state prescribed practices to SSAP 108.

- A new reporting schedule and separate disclosures to capture information for these specific derivatives and hedging programs are being developed and are expected to be exposed for comment shortly.

Guidance not revised, but subject to significant previous discussion, include a ten-year amortization period for the deferred hedging assets and liabilities and a five-year amortization period when the assets/liabilities relate to terminated or ineffective hedges, and the conclusion that a change in hedge target is a change in hedging strategy.

The proposed effective date is still undecided. The ACLI supports a January 1, 2019 implementation date with early adoption permitted for year-end 2018. However, some regulators continue to state a preference for an effective date consistent with the implementation date of the recommendations of the Variable Annuity Issues Working Group. (See further discussion in the summary of that working group below.)

Reinsurance risk transfer for short duration contracts (#2017-28) – The informal Life and Health and P&C Reinsurance Drafting Groups held frequent conference calls this spring and summer to continue work on proposed modifications to SSAPs 61R and 62R to clarify risk transfer, reinsurance credit and other related issues. At the Summer National Meeting, the working group exposed for comment proposed revisions to those SSAPs. The two drafting groups are currently focused on different issues and are discussed separately below.

SSAP 61R - The drafting group recommends new guidance in the Q&A section of Appendix A-791 to clarify the definition of "certain non-proportionate reinsurance contracts" that are excluded from the scope of A-791. The revisions also propose new guidance for ceded health insurance business that is subject to the MLR or other mandatorily required refunds or rebates and the need for the reinsurer to participate in its share of the refund. New disclosures to capture "risk limiting" reinsurance contracts, modeled on the SSAP 62R disclosures in paragraphs 93-98, are also proposed. The drafting group is not recommending adoption of these changes until other revisions are developed and discussed.

SSAP 62R - The P/C Drafting Group focused on which GAAP guidance should be added to SSAP 62R (vs incorporation by reference). Most of the proposed revisions incorporate wording from EITF 93-6 on multi-year retrospectively rated reinsurance contracts.

Regulatory Transactions Referral from the Reinsurance Task Force (#2018-06) – The working group had originally exposed for comment proposed new wording for SSAP 4 to allow admitted assets only to the extent that the regulatory transaction had been approved for admittance by the domiciliary regulator. Based on feedback from industry, the proposal was modify to narrow the scope to "invested assets," but would still be subject to disclosure as a permitted or state prescribed accounting practice that differs from NAIC prescribed. In addition, even if rated by a CRP, the insurer would not classify the investment as filing exempt.

Based on the interested party comment letter, industry participants may continue to have concerns with the revised proposal due to the broad definition of a regulatory transaction being “a security or other instrument in a transaction submitted to one or more state insurance departments for review and approval under the regulatory framework of the state or states.”

SSAP 41R – Surplus Notes Linked to Other Structures (#2018-07) – The SAP Working Group re-exposed for comment proposed revisions to SSAP 41R to disallow capital treatment for surplus notes which are linked to other products that are not subordinate. The revised wording includes the following:

> surplus note accounting is prohibited in any situation in which a reporting entity has “linked” the cash flows payable from an issued surplus note with cash flows receivable under any other agreement or held asset. Such dynamics include, but are not limited to, situations in which terms negate or reduce cash flow exchanges, and/or when amounts payable under surplus notes and amounts receivable under other agreements or assets can be netted or offset (partially or in full) eliminating or reducing the exchange of cash or assets that would normally occur throughout the duration, or at maturity, of the agreement, asset or surplus note.

The revisions were made in part to address concerns that the previously exposed guidance referring to surplus notes “linked (directly or indirectly) to other products or transactions” was too broad and would scope in unintended transactions.

SSAP 21 – Other admitted assets and private placement life insurance and variable annuities (#2018 -08) – After significant feedback from industry, the working group finalized guidance on insurance policies owned by insurance entities. Such policies will continue to be admitted assets under SSAP 21 when compliant with IRS Code § 7702, which defines life insurance for tax purposes. The working group agreed to allow policies that include investment risk to the policyholder, but insurers will now be required to disclose the amount of the cash surrender value that is within an investment vehicle by investment category (e.g. bonds, common stock, joint ventures, etc.). The adopted guidance also requires that the policies “shall be acquired with the primary consideration of the costs related to employee benefit obligations or costs related to a key person.” The net realizable value related to policies not complaint with § 7702, including variable annuities, will be non-admitted. The guidance is effective for year-end 2018.

FASB guidance on long duration contracts - The working group stated that they plan to review the FASB guidance “immediately” after issuance. ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts, was issued August 15. See PwC’s In brief document for further discussion of this new ASU.

Blanks Working Group

Since the Spring National meeting, the working group adopted twenty-one proposals for year-end 2018 (unless otherwise noted). The more significant of these adoptions are as follows:

- Update the language in the Schedule DB, Part D, Section 1 instructions, adding a definition of exchange traded derivatives and providing other clarifications. (2018-01BWG)

- Align the life and annuities types of reinsurance to be consistent between ceding and assuming schedules and revise the health types of reinsurance to be consistent with more common terminology. (2018-04BWG)

- Revise the P/C Statement of Actuarial Opinion instructions to incorporate AG 51 (long-term care) requirements and increase disclosures for accident and health business reported on a P/C blank. (2018- 05BWG)

- Add 1) new “PL” and “PLGI” symbols to the investment schedules and instructions to identify private letter rated securities, 2) a “YE” and “IF” symbol as indication of a new “carry-over” administrative procedure of the SVO, 3) a general interrogatory for PL securities issued prior to January 1, 2018, and 4) use of 5GI to replace the 5* GI designation. The definition of the symbol “Z” was modified to indicate a security in transition from one reporting status to another. These changes are effective for annual 2018. (At the VOS Task Force meeting in Boston, the SVO noted that the technology component of this “carryover procedure” won’t be implemented until year-end 2019 and companies should continue to use the existing “Z” rules for 2018.)

  The adopted proposal also removes designation matrices from the instructions and replaces them with a list of administrative symbols valid for use on Schedule BA and Schedule D, and adds specific line categories for perpetual preferred and redeemable preferred stock. These changes are effective annual 2019. (2018- 07BWG)

- Add an illustration for Note 8H to be data-captured and electronic-only columns and other changes to Schedule DB to implement the derivatives with financing premiums guidance proposed by the SAP Working Group. (2018- 12BWG)

- Modify the VM-20 Reserves Supplement, Part 3 and Exhibit 5 and instructions to be consistent with the changes made to the Valuation Manual. Add a new Part 4 for the reporting of "Other Exclusions from Life PBR." (2018-13BWG)

- Eliminate the fraternal blank and combine the reporting of life and fraternal companies into one life blank, effective for the first quarter of 2019. (2018-18BWG)

- Add new liquidity disclosures for year-end 2019 proposed by the Liquidity Assessment Subgroup; Note 32, Analysis of Annuity Actuarial Reserves and Deposit Type Contracts by Withdrawal Characteristics was expanded and new Note 33, Analysis of Life Actuarial Reserves was approved. (2018-21BWG)

- Reformat the Life and Fraternal Analysis of Operations and Analysis of Reserves schedules beginning year-end 2019 to provide additional liquidity information. The working group also exposed for comment instructional changes to these schedules, which will be discussed on the working group's next conference call October 3.

The working group also modified and re-exposed the proposal to update the columns and rows on the Summary Investment Schedule to tie to the different investment schedules (2018-02BWG). Additionally, the working group adopted reporting guidance for Supplemental Health Care Exhibit related to the Affordable Care Act Quality Improvement Adjustment, which will be posted to the website.

Risk-based capital

The regulators made the following significant progress on RBC projects. (Appendix B summarizes other actions taken by the various RBC Working Groups since the Spring National Meeting.)

Operational risk

Life RBC growth risk charge – The Operational Risk Subgroup resumed discussion of developing a growth risk charge for the life formula, since unlike the P/C and health formulas, life RBC does not include a provision for growth risk. (The formula currently does include an informational growth risk calculation on LR029-A.)

During its August 20 conference call, the subgroup approved exposure of a conceptual approach to an "enhanced add-on" method which would apply an additional RBC charge if triggered by significant growth year over year. The example used during the discussion was a 1.5% additional charge (above the 3% operational risk charge effective for 2018) if a life insurer has more than a 20% increase in gross premium (which is the current informational growth premium trigger). During the subgroup's June 7 conference call, both the ACLI and the AAA had commented that a standalone growth risk factor may not be necessary since other RBC requirements reflect growth risk such as the life trend test and basic operational risk.

The subgroup also exposed for comment a proposal to gather information about operational risk through the ORSA filing process since the insurance industry was very resistant to the idea of data collection for an operational risk database. Both documents are exposed until October 5.

Investment RBC

Bond factors – At the Summer National Meeting, the chair of the Investment RBC Working Group made the big announcement that it is now "much more likely" that implementation of the 20 NAIC designation categories will be for year-end 2020 RBC, and that 2019 implementation is "more of long-shot." The reason given was that additional time is necessary to update NAIC systems so that they can accept the 20 new designation categories. The co-chair asked to understand the specific reasons why 2019 may not be achievable and NAIC staff will prepare a memo for future discussion. Even if not implemented until 2020, the chair would like to adopt the final life bond factors at the upcoming Fall National Meeting.

The working group then discussed the AAA's analysis of the statutory reserve offset in the bond factors, which was the final assumption that the working group had agreed to re-review, at the request of the ACLI. This assumption is also referred to as the spread adjustment concept i.e. the amount of credit risk included in policy reserve assumptions.

The AAA concluded that there have been "no changes to the statutory reserve standards that justify a change to this assumption." This resulted in a spirited discussion between the AAA and ACLI representatives, with the ACLI referring to this "pretty big assumption" as "squishy." The working group voted to expose the AAA's July 17 letter for comment until October 4.

The working group received the 137 page report from the AAA Joint P&C/Health Bond Factors Analysis Work Group with its proposed bond factors for P/C and health entities. Assumptions include a 5 year time horizon for modeling P/C investment grade bonds and 2 years for health, based on the respective liability run off time horizons. The base risk factors for P/C and Health bonds are included in the work group's report, and are smaller factors for 15 of the 20 designation categories, some of which are significantly lower.

Consistent with prior meetings, the Investment RBC Working Group expressed concerns regarding the use of the shorter time horizon since the ten year time horizon for life bond factors is based on a complete credit cycle, not average life reserve duration, and this assumption is a primary driver of the lower proposed factors. The co-chair asked whether other assumptions had been modified as a result of the use of the shorter time horizon and the work group chair responded affirmatively. The report was exposed for public comment until October 4.

Life RBC

Effect of tax reform on life RBC – As discussed in PwC's NAIC Newsletter Update in July, the Life RBC Working Group adopted significant changes to the 2018 Life and Fraternal RBC formulas to reflect the change in the corporate tax rate to 21% as a result of tax reform. The changes to the formula are pervasive, revising tax factors and certain pre-tax factors throughout the formula. The changes were adopted as final by Plenary at the Summer National Meeting. The related changes to the AVR factors (which are after tax) are expected to be effective for 2019.

The working group is drafting a communication for regulators and other users to explain the changes to the formula so that users can distinguish between a change that is due to tax reform and a change due to something else. A detailed outline of the guidance was distributed at the Summer National Meeting, which notes that the estimate of the increase to required capital is generally between 10% and 15%, which will cause RBC ratios to "decrease significantly for all life insurers." The working group hopes to finalize the communication this fall.

Longevity risk – The AAA's Longevity Risk Task Force reported on the field study they recently conducted to inform their proposed methodology for developing longevity risk factors to be applied to reserves in the RBC calculation. Seventeen companies submitted data and the study tested the impact to statutory reserves of shocks in base mortality rates and mortality improvement rates. Companies were asked to provide data at a granular level to understand how product type, valuation discount rate, policy duration, age and gender effect risk.

The AAA task force expects the longevity risk charge will be applied to formula statutory reserves for products in scope. They anticipate having a proposed implementation approach for discussion at the Fall National Meeting with possible inclusion in the Life RBC formula for year-end 2019 (but 2020 appears more likely).

Mortality risk – The AAA's C-2 Work Group is reviewing the assumptions and methodology for life insurance (individual, industrial, group and credit life). This includes replicating the methodology used to develop the current factors and understanding the mortality risk charges of other capital regimes such as Solvency II. The work group will consider factor bases more granular than the current approach such as product type, underwriting and in-force size. The work group anticipates a recommendation of a set of revised factors in 2019 or 2020; no implementation date has been formally proposed.

Schedule BA investments

Both the P/C and Health RBC Working Groups considered the effect on RBC if Schedule BA investments are assigned NAIC designations, which would allow the "look-through" treatment for RBC that is currently permitted by life RBC filers. Both working groups concluded that no change is necessary since the effect on P/C and health companies would be minimal (i.e. 95% and 98% of entities, respectively, have no Schedule BA assets with the underlying characteristics of fixed income investments). As recommended by the Capital Adequacy Task Force, the working group agreed to defer any proposed changes to the annual statement for at least a year.

Health RBC
Health Test – The Health RBC Working Group discussed its concerns with the test in the annual statement instructions that determines whether an entity files the health blank. The chair noted that 28% of short-term health premiums are reported on life blanks, and that the "missing data" likely affects the factors used for health RBC. The working group agreed to form an ad hoc group with both regulator and industry members to explore possible changes to the health test.

Valuation of Securities Task Force

The task force has made progress on the following projects.

Private letter rating process
The SVO reported that all seven CRPs that issue private letter ratings have committed to submitting data to the SVO; PL reporting is expected to be available to insurers for year-end 2018.

P&P Manual amendment adoptions and exposures
NAIC Designation Categories – The task force adopted the proposed 20 NAIC Designation Categories for securities related to the RBC granularity proposal: NAIC 1 will include 7 categories (1.A-1.G), NAIC 2-5 will include 3 categories (A-C), and there will be one category for the current 6 rating class. The adopted P&P Manual guidance includes a mapping of all CRP ratings to the 20 designation categories, e.g. a Moody's A1 rated security translates to an NAIC 1.E designation category.

P&P Manual reorganization - The task force adopted revisions to the manual to include filing instructions, documentation requirements and analytical methodologies in one place in the Manual (versus separate sections for each) for six additional topics, e.g. credit tenant loans, structured transactions etc.

The task force also exposed for comment the proposed new format and content of the P&P Manual, which is part of its continuing simplification effort. A goal of the reformatting is to "organize communications by type so the reader can locate topics more quickly." The proposed revisions are extensive and are exposed for comment until October 20. (A clean and "mapped" version of the Manual is posted to the VOS Task Force webpage.)

MFE process elimination – The task force exposed for comment until September 10 a proposal to remove the MFE process from the P&P Manual, which would result in non-modeled SSAP 43R securities being converted from CRP ratings with no adjustments. During discussion of the proposal, the chair noted that modified FE was necessary during the financial crisis because the credit ratings didn't reflect real risk and investments were trading far below par. The markets have now stabilized and the use of MFE creates arbitrage and unusual results; with the implementation of 20 rating classes, MFE would become more unwieldly.

An insurance company representative requested phase-in of the proposal or grandfathering the securities until sold since removing the MFE treatment would be punitive for investments purchased at a discount, particularly for large investors in foreign securities.

The task force originally suggested year-end 2018 implementation but at the meeting of the SAP Working Group, the regulators revised the proposed effective date to January 1, 2019 with earlier adoption permitted, to allow additional time to update systems and also asked for feedback for alternative transition provisions. The proposal could be adopted later this year.

Regulatory transactions
The Reinsurance Task Force has asked the VOS Task Force to define the term "regulatory transaction" and to provide guidance to regulators to assess such transactions. The VOS Task Force recognized there are concerns about the request, including that the SVO "is not a source of expertise on regulatory transactions." During its June conference call the task force exposed for comment proposed changes to the P&P Manual that state the following: "whether a Regulatory Transaction as defined in this Manual has any status under Model #785, Model #786, Model #830 or Model #787 is not an issue within the scope of charges entrusted to the VOS/TF or within the analytical function or role of the SVO or SSG."

The SAP Working Group is currently addressing the accounting of regulatory transactions that include invested assets, and during the VOS Task Force conference call, SAPWG staff noted that the working group may be asked to develop guidance to identify regulatory transactions in statutory financial statements.

Working capital finance investments
The task force agreed to consider possible revisions to the P&P Manual to allow the SVO more discretion in approving working capital finance programs as admitted assets of companies. Very few of these transactions have been done in the four years since SSAP 105 was adopted and the task force heard feedback that this is due to the requirements being overly prescriptive.

Group capital calculation

The working group met four times since the Spring National Meeting to continue progress on its project to construct a U.S. group capital calculation using an RBC aggregation methodology. The working group plans to do detailed field testing in 2019 which the chair believes is a "fresh opportunity" to consider the concepts discussed for the past several years (and for most there is not yet consensus).

Captive insurers
During its April conference call, the working group again discussed at length the treatment of captives in the group capital calculation (GCC). After hearing feedback from regulators, insurance companies and trade associations, the working group instructed NAIC staff to develop a calculation based on the original "aggregation and calibration" proposal to be used in field testing, with the goal of testing group capital with and without adjustments for unwinding captives. (The aggregation and calibration proposal had been presented by the ACLI, which does not support its use for this purpose.)

During this discussion, the working group member from Connecticut had suggested for the group capital calculation that a consistent valuation method should be used for both new and in force XXX/AXXX business, which was supported by representatives from Texas, Nebraska, New Jersey, New York and DC. This approach is also supported by some insurers but not by others.

Surplus notes and senior debt
The working group held a separate conference call in April to discuss a revised NAIC staff memorandum that proposes treatment of surplus notes and senior debt in the GCC, and considers limitations on including such amounts as group capital. A key open question continues to be how to recognize double leverage for structurally subordinated debt as available capital. Six comment letters were received on the revised draft, and the working group has asked staff to update the memo for feedback received for a future call, which is not yet available.

Scope of the calculation and non-regulated entities
The working group held an interim meeting in June and met in Boston to continue discussion of what entities should be subject to the GCC and the treatment of non-regulated entities. The result of this dialogue was exposure of a revised NAIC memo entitled "Scope of Group/Non-insurance Testing" dated August 8 with significant edits by the joint P/C trade associations and field testing questions added by NAIC staff. The memo details general concepts and proposed technical specifications and options to be used for field testing and analysis of a proposed group capital calculation.

Groups proposed to be exempt from the GCC include 1) non-U.S. based groups in a Reciprocal Jurisdiction that accepts the GCC from U.S. based groups to satisfy the Reciprocal Jurisdiction's group capital requirement, and 2) U.S based groups not required to file an ORSA summary report with the Lead State Regulator. The exclusion for ORSA filers is a very significant revision to the draft document.

The field testing plan would require an initial inventory of all potential entities, using Schedule Y as a starting point and then removing non-insurance, non-financial entities with low risk to the insurer using several prescribed tests. With respect to regulated financial entities, banks would be included using the minimum capital required by their regulators, and the GCC template would test both unscaled and scaled to an RBC equal to 300%. All asset managers and registered investment advisors would be tested using both 22.5% of book adjusted carrying value and 12% of three-year average revenue. Unregulated financial entities would assessed a 22.5% charge or other factors proposed by the volunteer testing participants. The memo was exposed for comment until September 21.

Throughout these discussions, some health insurers and trade associations have argued that health entities should be wholly exempt from the GCC due to their short tail of claim liabilities, stable loss ratios and no history of catastrophic risks. The working group has not yet agreed to this request and has asked that industry propose an alternative calculation (which other health insurers appear to be working on).

Reinsurance Task Force

Covered Agreement
In June the task force exposed for comment its first draft of proposed changes to the Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786) to incorporate relevant provisions of the new Bilateral Agreement between the U.S. and the EU. At the Summer National Meeting, the task force heard verbal comments from many of the 18 national and international companies, trade associations, and state insurance departments who submitted written comment letters. The comment letters received were in general agreement with the approach, but cited concerns regarding potential disparate treatment for non-EU jurisdictions and the need for qualified jurisdictions to provide to the states the same treatment and recognition afforded by EU countries including recognition of states' approach to group supervision, including group capital. Interested parties also suggested combining the Model Law and Model Regulation or moving some of the detailed language from the Regulation into the Law so there is more enforceability. Several comment letters cited concerns that commissioner discretion without parameters may lead to inconsistent implementation.

The task force will consider the comments and incorporate revisions into the next drafts of Models #785 and #786, which will be exposed prior to the Fall National Meeting. They noted that many of the comments are technical in nature and do not change the general direction. The task force believes it is on schedule to adopt final revised models before year-end.

Qualified Jurisdiction Working Group
The working group reported it will begin work on its charge to revise its Process for Developing and Maintaining the NAIC List of Qualified Jurisdictions as a result of the Covered Agreement, which it expects to complete by the Fall National Meeting.

Reinsurance Financial Analysis Working Group
The working group plans to consider changes to its current methods of monitoring certified reinsurers domiciled in qualified jurisdictions to incorporate changes to state collateral requirements as a result of the Covered Agreement and changes to the credit for reinsurance models. The goal is to complete this project by the 2019 Fall National Meeting.

Principles-based reserving

Valuation Manual amendment proposals
Following the Spring National Meeting, Life Actuarial Task Force activity focused largely on VM Amendment Proposal Forms, which resulted in LATF adopting several APFs to clarify guidance in the Valuation Manual. Perhaps the most notable adoption was an amendment that prescribes valuation mortality for guaranteed issue (GI) business issued after December 31, 2019 as the 2017 Commissioners Standard Guaranteed Issue Mortality Tables (2017 CSGI), where the 2017 CSGI tables reflect a 75% load on the GI Basic ultimate mortality table. Regulators also considered a 55% load, but after review of both loads, voted in favor of the more conservative load. Another substantive change adopted clarified that it is not permissible under VM-20 9.B.1 to adjust initial margins to recognize margins present in other risk factors.

At the meeting in Boston, the task force discussed several APFs that had been exposed for comment. APF 2018-17 received heavy airtime, which proposes clarifications to the aggregation of mortality segments in determining credibility under VM-20. The current proposed revisions allow aggregation if two conditions are met: i) the mortality segments were subject to the same or similar underwriting processes, and ii) the aggregate mortality experience was used to establish the company experience mortality rates for the mortality segments pursuant to Section 9.C.2.d.. Proposed changes also include annual monitoring of experience mortality for segments resulting from sub-division of an aggregate class, and clarifications as to what constitutes similar underwriting processes. LATF will continue discussion of this APF on a future conference call.

YRT Reinsurance Premium Considerations
Another topic of lengthy discussion in Boston by was an AAA letter to LATF raising the issue of what, if any, future increases to nonguaranteed yearly renewable term reinsurance premiums should be reflected in the deterministic and stochastic reserves. VM guidance on this topic is limited and may result in inconsistent reserves across companies having similar reinsurance arrangements. LATF heard comments from the ACLI and four industry members, recommending different perspectives, ranging from prescribing a standard and more conservative approach for both insurer and reinsurer, to application of prudent actuarial judgment and disclosure in the PBR Report.

VM-22 fixed annuity PBR
LATF heard updates from the VM-22 Subgroup, the Academy SVL Modernization Work Group and the Academy Annuity Reserves Work Group on activities related to fixed annuity PBR. The VM-22 Subgroup has not met since the Spring National Meeting but is following activity of the Academy work groups.

The SVL Modernization Work Group is focused on modernizing the valuation rate setting process for all non-variable annuities, effectively phase two of the VM-22 work for immediate annuities. The approach currently under consideration reflects an initial single rate, locked-in at issue and updated quarterly. The initial rates would be based on representative industry asset portfolios varying by product characteristics, with the goal of matching asset and liability duration at issue. Valuation rates for modeled reserves under the anticipated PBR framework would be solved for by matching modeled liabilities with modeled investment income on assets for different products and features. The work group is examining results under level, rising and falling scenarios and plans to develop adjustments to relate the initial portfolio yield at time zero to the solved-for rate on modeled liabilities. The initial list of differentiating product features includes guarantee period, surrender charge period, market value adjustments, partial free withdrawals, guarantees on future premiums and guaranteed living benefits.

The Annuity Reserves Work Group updated LATF members on development of the non-variable annuity exclusion test. The expectation is that if the exclusion test is passed then the VM-22 approach will follow current actuarial guidelines (e.g. AG 33), and if it is not passed then the VM-22 approach will follow a VM-21-like framework (AG 43).

The work group is considering a potential exclusion test methodology whereby calculation of the modeled reserve is optional if the formulaic CARVM reserve is less than or equal to the cash surrender value or account value. The rationale for this approach is rooted in the fact that asset adequacy testing of formulaic CARVM reserves generally demonstrates the formula reserves are adequate (i.e. that CARVM generally produces overly conservative reserves rather than inadequate reserves). Asset adequacy testing will still be required, and the expectation is that modeled reserves would, by design, produce reserves that satisfy asset adequacy requirements.

The work group expects that exclusion testing at issue should be sufficient for most product designs, but other designs (e.g. those with variable forms of future guarantees) may require updated testing. The test would be prescribed as a per-policy test but could, in many cases, be performed at a plan code or policy form level.

Variable annuities framework

The Variable Annuity Issues Working Group held two conference calls in July and held an all-day meeting in May to finalize the revised variable annuity statutory framework which included an exposure to receive final comments. The framework was developed by Oliver Wyman (OW) in collaboration with state regulators and key industry representatives.

Prior to a working group vote to adopt, the American Council of Life Insurers noted that while the revised framework is not entirely principles-based, it successfully reduces incentives for the use of captive reinsurance companies, which was the primary charge assigned to the working group. However, the American Academy of Actuaries stated that it is not able to confirm that the new framework meets the stated goals (e.g. reducing or eliminating the incentive to reinsure to captives and reducing non-economic balance sheet volatility), and is unable to confirm which of the 27 recommendations will have the most significant impact.

The Financial Condition Committee voted to adopt the revised VA reserves and capital framework on July 31 (with the long official title of "Revisions to AG 43/VM-21 and C3 Phase II"), which was confirmed by the full NAIC at the Summer National Meeting. New York formally voted "no" to the revised framework.

With the adoption of the final framework, the working group noted that there are several key outstanding items. One issue pertains to the removal of VA hedging asset admissibility caps at the state level. This will be handled by a separate working group. Additionally, the Life Actuarial Task Force will evaluate the use of the adopted standard scenario over time. Specifically, they will address whether the Standard Scenario Amount will remain a binding minimum reserve, or be changed to a disclosure-only item. This will be evaluated over the three year period following the implementation of the new framework or after the next market downturn. Some regulators have expressed concern over removing the Standard Scenario as a binding minimum reserve without actual experience regarding how the stochastic principles-based framework will behave in a market downturn. The existing AG 43 framework has been in place over a sustained up-market since its implementation at the end of 2009. The working group will also continue to monitor and oversee the future development of the prescribed assumptions used in the Standard Scenario calculation as relevant industry experience emerges.

The target effective date of the adopted reforms is planned for January 1, 2020. In the interim, technical specifications of the new framework will be developed. The possibility of an earlier adoption by insurers is also being considered. Some regulators have expressed a preference that the new VA framework implementation coincide with the proposed implementation of the new hedge accounting framework as of January 1, 2019. See the summary of the SAP Working Group for discussion of the VA hedging project.

Retirement security initiative

The Life Insurance and Annuities Committee discussed its charge on retirement security and the possibility of developing "unbiased" educational materials in an online format. This included debating the merits of putting resources toward developing educational materials and tools, similar to those that have been created for investor education, which would serve as a resource for consumers to obtain unbiased guidance given there are a number of varying and complicated products in the market. The committee discussed whether there should be a working group for digital resources, somewhat similar to the Life Buyer's Guide Working Group. They further discussed that if they decide to create educational materials, then they also need to determine who the target audience is since retirement education varies by age group (e.g., a younger audience would need more first-time buyer support and would likely prefer online tools than paper manuals or consumer representatives).

Committee members noted that their belief that the content for the education exists throughout the NAIC; it is just a matter of whether they should catalogue it, create a tool and maintain it, and work to coordinate the various NAIC working groups that touch on retirement products. A number of committee members support the initiative; therefore the committee agreed to further define the project for consideration at the Fall National Meeting.

Life Actuarial Task Force

In addition to progress on PBR initiatives, the task force continued work on the following projects.

Accelerated underwriting mortality
At the meeting in Boston, the Joint Academy/SOA Preferred Mortality Project Oversight Group (joint committee) presented the results of the committee's recently completed Delphi study to gather expert viewpoints regarding emerging underwriting methodologies and their impact on future mortality experience, and presented an updated recommendation for data collection based on feedback from the initial exposure. The study is available on the SOA website.

The results from the study are intended to provide practitioners and regulators with a framework that clarifies how to categorize different underwriting practices, benchmarks adjustments to base mortality tables for different practices, and guides whether further refinements to VM-20 are needed to accommodate emerging practices relative to the determination of the anticipated mortality experience assumptions. To accommodate the anticipated changes in mortality risks emerging from AU programs, the joint committee recommends clearer guidance around aggregation of mortality in determining the anticipated mortality assumption (which is now proposed in APF 2018-17), and possible additions to the AAA VM-20 practice note.

The joint committee also discussed the challenges AU programs present for collecting mortality experience data and developing traditional mortality tables. Variation in emerging practices and the growing number of different factors considered in AU programs will make it difficult to measure industry trends and create single mortality tables to represent various underwriting regimes. In addition, mandatory data collection under VM-51 does not adequately capture the data necessary to differentiate and understand the different underwriting programs and expected mortality. Such data includes marketing channel, definitional data, data sources, underwriting program factors, lab data for fully underwritten products, and application data.

An initial request for additional industry data was discussed at the Spring National Meeting, and at this meeting the joint committee presented a revised data request that includes different granularity and requirements for mandatory data phased in over 1-4 years. The proposed AU Data Request file can be found on the LATF webpage. No further action was taken at this meeting and discussion will continue on a future call.

Individual annuity nonforfeiture
At the Summer National Meeting LATF members heard an update from the Model #805 (Standard Nonforfeiture Law for Individual Deferred Annuities) Drafting Group on its work to address determination of individual annuity nonforfeiture values in compliance with the Model #805 prospective test. At the Spring National Meeting, the task force voted to expose for comment a draft actuarial guideline that addresses treatment of common annuity features like bonuses, charges, market value adjustments, treatment of optional maturity dates, and testing required to certify compliance with the law. The guideline emphasizes gradual convergence of cash surrender benefits to the paid-up annuity benefit available at maturity, deemed to be the later of age 70 or the tenth policy anniversary (the "70/10 test").

Discussion continued at the meeting in Boston, as the drafting group noted very little "love" in the comments, which were focused primarily on the limitation imposed by the 70/10 test, as many states allow longer/higher surrender charge periods (which may extend the time to convergence). The drafting group noted the proposed guideline is consistent with the IIPRC (Compact) standards, and that commenters questioned the need for an actuarial guideline consistent with the Compact. Comments suggest a greater disparity between states and the Compact for this standard than for other standards. Discussion of this topic will continue on a future LATF call.

Academy Life and Health Valuation Law Manual
One topic of keen interest to LATF members and which is likely be of interest to many practicing actuaries is an update from the Academy Life and Health Valuation Law Manual Task Force, formed to review and make recommendations on the manual's purpose, scope, content, organization and functionality to serve evolving needs of the Academy membership. The Academy Manual is a trusted resource for actuaries seeking to comply with NAIC and state-specific valuation requirements, including asset adequacy and actuarial guidelines. The current vision for the updates includes a manual organized by topic with greater uniformity in how information is presented by state, helpful content summaries to provide "snapshot" views, and links to the NAIC website for model laws and regulations. The task force plans to implement as many changes as possible for the 2019 version, which will be available in January 2019.

Long-term care issues

Multi-state rate approval system
The Joint Long-Term Care Insurance Task Force heard a presentation from actuaries from the insurance departments of Idaho, Nebraska and Utah regarding a proposed multi-state rate approval system and the possibility of appointing a new subgroup to establish a process for such a system. The presenters noted the repetition of the current rate increase approval process, including filing for increases in multiple states, the fact that requests from additional information can vary by state, and conclusions by state can vary. They noted that there is already some existing coordination among states and that this could be the foundation for the proposed further cooperation. There was debate on what the exact purpose and function of the new system would be, whether a new subgroup is necessary, and the importance of state by state autonomy and whether a centralized function to approve rate increases would curtail this. More discussion is expected in the near term via conference call.

LTC actuarial topics
The LTC Combo Valuation Working Group is developing a Practice Note on LTC Combo Product statutory, GAAP and tax valuation methods and assumptions. The working group has surveyed the companies completing Form 4 of the 2016 Long-Term Care Experience Exhibit, and is currently drafting the Practice Note. The LTC Valuation Working Group is developing mortality and lapse tables as possible bases for statutory minimum reserve requirements; separate subgroups are addressing mortality and lapse. The mortality subgroup has developed best estimate mortality tables with dimensions of gender, issue age, risk class, marital status and policy duration. Work remaining is development of best estimate tables for active lives only. All work to date is on a total life basis. The valuation PAD also needs to be developed. The lapse subgroup is waiting on data from LIMRA to determine significant factors. Lapse rates will be developed for total lives and active lives only.

The LTC Pricing Subgroup has distributed a document for comment that illustrates two methods for the review of LTC rate increase filings known as the Blended Make-Up method (also referred to as "if knew") used by MN, and the Prospective Present

Value method used by TX. The subgroup expects to have a final document for the Fall National Meeting.

The LTC Valuation Subgroup has been coordinating with the regulator-only review of companies' AG 51 filings. The subgroup has made inquiries to companies filing AG 51 actuarial opinion memoranda regarding the use of morbidity improvement with comments related to assumptions of future rate increases and noted the prevalence of limited pay and paid-up LTC policies. The next steps for the Valuation Subgroup include issuing a guidance document for AG 51 with requirements for sensitivity tests to be effective for year-end 2018. Other next steps are addressing the company specific inquiries, and addressing the use of morbidity improvement as an assumption; a subgroup member stated that morbidity improvement for the general population is different than insured morbidity improvement.

The LTC Actuarial Working Group heard an update on SOA activities which include a published report entitled "Long-Term Care Innovations: An SOA Study Exploring New Long-Term Care Financing Options." This report discusses two new LTC product designs: one is a term life product that turns into LTC at older attained ages and the other is a 401(k) type account that funds LTC policies. Next steps for the study are to explore partnering opportunities with LTC carriers and to develop pilot programs.

Financial Stability Task Force

Liquidity stress testing

The Liquidity Assessment Subgroup had its first public meeting to discuss company stress testing methodologies. Based on feedback from a conference call in June, the subgroup concluded that its draft framework will use a cash flow approach, which determines a ratio of cash inflows to cash outflows and incorporates company-specific assumptions. The subgroup chair emphasized that this framework is meant to supplement, not replace, company-specific liquidity risk-management.

At its meeting in Boston, the Financial Stability Task Force discussed the subgroup's Scope Considerations and Design Elements Considerations for a Liquidity Stress Test. The documents suggest the following life insurer activities and thresholds that might trigger the requirement to perform stress testing: issuance of fixed and indexed annuities ($25 billion of reserves), funding agreements and GICs ($10 billion of reserves), derivatives ($1 billion of fair value totals from Schedules DB Part A and B), securities lending ($2 billion in fair value reported on Schedule DL), repurchase agreements ($1 billion) and borrowed money ($1 billion in carrying value). The subgroup has asked for comments on the documents by August 31.

Risk-focused surveillance

In 2017, the Risk-Focused Surveillance Working Group agreed to form an Efficiency Drafting Group to review suggestions from interested parties to reduce redundancies in solvency monitoring efforts. The drafting group then developed recommendations and at the Summer National Meeting, the working group discussed the comments on the proposals. The recommendations included proposed revisions to the Financial Condition Examiners Handbook to leverage work performed as part of the risk-focused analysis process including 1) modification to Section 1, Phase 1 and Exhibit M to consider group issues during the exam and to encourage examiners to leverage the analyst's work already performed, and 2) modifications to Exhibit B, Examination Planning Questionnaire, to align with the current examination process and reduce unnecessary requests. The drafting group also developed new guidance, Exhibit D, Planning Meeting with the Financial Analyst, which includes proposed agenda items for discussion between the examiner and the analyst. The working group believes Exhibit B will be a useful new tool.

The working group voted to refer the updated recommendations to the Financial Examiners Handbook Technical Group and the Financial Analysis Handbook Working Group for consideration.

MAR internal audit requirement

During the July conference call of the NAIC/AICPA Working Group, staff reported that 19 states have now adopted the revisions to the Model Audit Rule (#205) that require companies with written premium in excess of $500 million to have an effective internal audit function. Because these revisions are an accreditation standard as of January 1, 2o20, the chair encouraged the remaining states to continue their efforts to adopt the required guidance.

International Insurance Relations Committee

Comment letters
This spring, the committee approved submission of NAIC comments on the FSB Consultative Document "Recommendations for Consistent National Reporting of Data on the Use of Compensation Tools to Address Misconduct Risk" and the SIF-IAIS "Issues Paper on Climate Change Risks to the Insurance Sector." The latter document is discussed in the summary of the Climate Change and Global Warming Working Group.

IAIS update
IAIS staff gave an update regarding the Strategic Plan & Financial Outlook and implementation activities. Themes from these activities include the view that the insurance world is rapidly changing due to technology and other factors, and that the IAIS needs to assist supervisors in this regard now that policies in a post-financial crisis world are mostly finalized, with an emphasis in work with emerging markets.

With regard to standard-setting, the IAIS is working on revisions to Insurance Core Principle 20, Disclosure, and ICP 6, Changes in Control, which were released for public consultation in June; a number of other consultation documents are also out for public comment, including application papers covering cyber risk, proactive supervision of governance and the role of the board, and an issues paper on how digitalization is impacting the conduct of business and the use of personal information. In addition, the revised version of ComFrame and ICS version 2.0 has recently been released for a 90-day public consultation and is currently being reviewed by users.

Financial Regulation Standards and Accreditation Committee

2014 Revisions to Holding Company Model
At the Summer National Meeting, Executive Committee and Plenary adopted as an accreditation standard effective January 1, 2020, the 2014 changes made to Insurance Holding Company Regulatory Act (#440) to clarify and confirm to international and federal regulators that the states have the authority to act as the group-wide supervisor of a large U.S.-based internationally active insurance group when the group meets specific size criteria.

Revisions to Review Team Guidelines
The committee adopted revisions to require the use of a credentialed actuary on financial exams of companies that have a substantial amount of business subject to PBR calculations or exclusion tests. The committee also exposed for comment proposed guidelines for the timing of review by analysts of ORSA summary reports and guidance for insurance departments using contractors as primary supervisors for financial analysis.

P/C Appointed Actuary attestation

The Casualty Actuarial and Statistical Task Force has been tasked with the development of an actuarial attestation form that would be completed and signed annually to verify that the actuary is qualified to sign a statutory P&C Statement of Actuarial Opinion. After extensive discussion with practicing actuaries over multiple meetings in 2018, the task force has backed away from the initial proposal to require 100+ "knowledge statements" in every actuarial opinion. This has been replaced with a movement towards confirming that the knowledge statements are covered in each syllabi (SOA or CAS) and then an annual attestation of compliance as it relates to the specific qualification standards. Additionally, as part of the attestation each member would be required to create a summary log of continuing education activities. The NAIC proposal suggests CAS and SOA develop a common summary log which would be made available upon request along with an annual attestation as well as an audit of a percentage of the members who attest as set by the organizations in conjunction with the NAIC.

At the Summer National Meeting, the task force discussed a proposed revision to the actuarial opinion requirements maintained in the P/C annual statement instructions. New wording includes the following:

> The Board of Directors shall document the company's review that the actuary meets the requirements to be a Qualified Actuary. The actuary shall provide detailed qualification documentation to company management annually and include a summary of such documentation in the subsequent Actuarial Report. All items in the definition of "Qualified Actuary" must be addressed in the detailed and summary qualification documentation. The detailed qualification documentation, not just a summary, shall be available for inspection upon regulator request or during a financial examination.

The proposal also suggests that the detailed documentation be available to the regulator for 7 years. The task force hope to finalize the new requirements for 2019 actuarial opinions.

Climate change assessment tools

The working group heard an overview of the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations for investors/ asset-owners from the United Nations' Principles for Responsible Investment. The Financial Stability Board industry-led TCFD provides a global framework to translate non-financial information into financial metrics. The PRI has nearly 400 signatories in the United States, including various insurance companies and their asset-manager subsidiaries. The presentation provided an overview of the PRI's recently released guide providing practice tools and guidance to support asset owners in implementing the TCFD recommendations. These recommendations include near term actions and recommendations for engagement with fund managers on climate-related issues management, particularly surrounding governance, strategy, risk management, and metrics and targets. The TCFD proposed that these recommendations will create a common international framework through which investors and companies can make informed decisions about their exposure to climate-related risks and opportunities.

The working group also heard a presentation from the United Nations Sustainable Insurance Forum on the development of best practices regarding climate risk for insurance regulators. The SIF, a network of insurance supervisors collaborating on sustainability, partnered with the IAIS to provide guidance to supervisors. The presentation focused on the jointly issued IAIS Issues Paper on Climate Change Risks to the Insurance Sector intended to inform supervisors on the changes in climate requiring financial risk assessment. The Issues Paper covers climate change background, the climate risk landscape, how climate change may specifically affect the insurance sector, insurance industry responses to climate risks, the relevance for insurance industry supervisors, the applicability of insurance core principles to climate change, example supervisory approaches to climate change risk, and observed practices and case studies. The chair encouraged the working group members to read the Issues Paper, which has been posted to the website.

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The next National Meeting of the NAIC will be held in San Francisco November 15-18.

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 at jean.connolly@pwc.com.

Appendix A

This table summarizes actions taken by the SAP Working Group since the PwC NAIC 2018 Spring National Meeting Newsletter on all open agenda items. Items exposed for comment are due October 5, 2018 unless otherwise noted. For full proposals exposed and other documents see the SAP Working Group webpage.

Issue/ Reference #	Status	Action Taken/Discussion	Proposed Effective Date
SSAP 22 - ASU 2016-02 - Leases (#2016-02)	Re-exposed	A substantively revised SSAP 22R was re-exposed for comment at Summer National Meeting, along with the proposed issue paper, which retains the guidance that all leases are operating leases. The revised SSAP 22R draft includes new guidance on sale-leaseback transactions to incorporate language from ASC 842-40 and add text from the current SSAP 22 that had been deleted in the first exposure draft.	Years ending December 31, 2019 with early adoption permitted
SSAP 86 - Special Accounting Treatment for Limited Derivatives (#2016-03)	Re-exposed	A significantly revised issue paper was re-exposed for comment at the Summer National Meeting, along with the first draft of SSAP 108, Derivatives Hedging Variable Annuity Guarantees. See additional discussion in the SAPWG summary above.	SAPWG asked for feedback on the effective date
ASU 2016-13 - Credit Losses (#2016-20)	Discussion deferred to an interim meeting	NAIC staff is continuing discussions with industry representatives regarding the intent of guidance in the exposed discussion document, which suggested adoption of certain concepts of ASU 2016-03. The regulators plans to hold a conference call to discuss this issue prior to the Fall National Meeting.	TBD
SSAP 41 – Surplus Note Amortization and Accretion (#2017-12)	Discussion deferred	NAIC staff continues to work with industry to resolve issues and propose related accounting for surplus notes issued at a discount. There was no discussion of this issue at the Summer National Meeting.	TBD
SSAP 61R and SSAP 62R – Reinsurance Risk Transfer for Short Duration Contracts (#2017-28)	Exposed	The working group exposed proposed revisions to SSAP 61R and SSAP 62R, which were drafted by the informal reinsurance drafting groups. See additional discussion in the SAPWG summary.	TBD
SSAP 30 – Investment Classification Project (#2017-32)	Exposed	The working group re-exposed a revised issue paper and exposed draft SSAP 30R to clarify the definition of common stock and to provide additional guidance on mutual funds and non-bond ETFs. The exposed papers reflect industry's comments to clarify that non-public stock warrants are scoped into SSAP 86 and that mutual funds, unit investment trusts and ETFs without a readily determinable fair value may be reported at net asset value.	January 1, 2019, with SAPWG asking for comments on the proposed effective date
SSAP 86 – ASU 2017-12, Derivatives and Hedging (#2017-33)	Project bifurcated	With input from interested parties, the SAP Working Group agreed to separate the issue paper into substantive and non-substantive changes with the possible adoption of certain revisions related to hedge effectiveness assessments in 2018. See the SAPWG summary above for additional discussion.	Non-substantive revisions could be effective January 1, 2019

Appendix A

SSAPs 49 & 56 – Policy Loans (#2017-35)	Adopted	At the Summer National Meeting, the working group adopted guidance for SSAPs 49 and 56 to clarify that a transfer of assets from the separate account to the general account must occur within 3o days to fund the policy loan issuance; otherwise the policy loan is nonadmitted in the general account. A new disclosure for policy loans admitted in the 30 day window was also adopted for quarterly and annual statements.	August 4, 2018
SSAP 101, Federal Income Tax Reform (#2018-01)	Adopted	The working group adopted guidance related to tax reform and its consideration of FASB's ASU 2018-02 on federal tax reform. See additional discussion in the SAPWG summary above.	May 24, 2018
SSAP 43R – Reporting NAIC Designations as Weighted Averages (#2018-03)	Deferred	The working group had exposed proposed revisions to require that for SSAP 43R securities with different NAIC designations by lot, the reporting entity shall either report the entire investment in a single reporting line at the lowest NAIC designation that would apply to a lot or report the investments individually by purchase lot in the investment schedules. At the Summer National Meeting, the working group decided to defer this issue until the proposal to eliminate modified filing exempt securities is concluded (#2018-09).	TBD
SSAPs 21 & 26 – Bank Loan Referral (#2018-04)	Deferred	At the Spring National Meeting, the working group exposed for comment a proposed recommendation to the VOS Task Force that "borrowing base loans" and "DIP financing loans" be classified as collateral loans as opposed to bank loans under SSAP 26R. Based on feedback from industry, the working group directed staff to perform additional research on these structures for future discussion.	TBD
SSAPs 1 & 32 – Security Symbol Changes (#2018-05)	Adopted	As a result of changes adopted by the VOS Task Force related to 5* securities and perpetual preferred and redeemable preferred stock symbols, the working group adopted revisions to SSAP 1 and SSAP 32 to reflect those changes including the use of the new 5GI symbol. See the Blanks Working Group summary for additional discussion.	May 24, 2018; the related Blanks changes will be effective for YE 2018
Regulatory Transactions Referral from the Reinsurance Task Force (#2018-06)	Re-exposed	The working group re-exposed for comment proposed new wording for SSAP 4 to address invested assets acquired in connection with "regulatory transactions." See the SAPWG summary for additional discussion.	TBD
SSAP 41R – Surplus Notes Linked to Other Structures (#2018-07)	Re-exposed	The SAP Working Group re-exposed for comment proposed revisions to SSAP 41R to disallow capital treatment for surplus notes which are linked to other products that are not subordinate. See the SAPWG summary for further discussion.	TBD
SSAPs 21 & 56 – Private Placement Variable Annuities (#2018-08)	Adopted	The working group adopted new guidance for SSAP 21 to allow IRS compliant life insurance policies owned by an insurer to continue to be admitted assets. See the SAPWG summary for additional discussion. The regulators also adopted a new disclosure for the separate account statement for products not registered with the SEC: insurers will disclose the total amount of assets related to private placement variable annuity products and private placement life insurance.	December 31, 2018 for the new disclosure

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SSAP 97 – SCA Cumulative Losses (#2018-09)	Adopted	The working group adopted proposed revisions to SSAP 97 to clarify the accounting and to require disclose by reporting entities whose share of losses in an SCA exceed the investment in the SCA. This will be required regardless of whether a guarantee or commitment of future financial support to the SCA exists. The new footnote will disclose accumulated share of net losses, amount of guaranteed obligations or commitment for financial support and SCA reported value.	December 31, 2018
INT 18-02T – 2019 ACA Section 9010 Moratorium (#2018-10)	Adopted	As a result of adoption of a 2019 moratorium on the health insurance provider fee (similar to 2017 moratorium), the working group adopted INT 18-02, which is modeled after INT 16-01 on the same topic. The interpretation also provides general guidance in the event of any future moratoriums of the provider fee.	May 24, 2018
Appendix D – ASU 2017-15 (#2018-11)	Adopted	The working group rejected this ASU related to U.S steamship entities as not applicable to statutory accounting.	May 24, 2018
Various SSAPs – ASU 2018-13 (#2018-12)	Adopted	The regulators rejected ASU 2018-03, Recognition and Measurement of Financial Assets and Financial Liabilities within SSAPs 26R, 30, 32, 43R, 86 and 100R.	May 24, 2018
Editorial Updates to Various SSAPs – (#2018-13EP)	Adopted	The working group adopted several NAIC staff proposed editorial revisions such as deletion of disclosure illustrations and an outdated footnote.	May 24, 2018
SSAPs 47, 54, 66, & 84 – Guidance for Covered GAP Discount Program (#2018-14)	Adopted	The working group adopted revisions to INT 05-05, Medicare Part D Definitions, to provide guidance for the Coverage GAP discount program. The guidance is similar to the existing accounting guidance for the low-income subsidies.	August 4, 2018
INT 18-03 – Additional Elements under the Tax Cuts and Jobs Act (#2018-15)	Adopted	The regulators finalized their Interpretation 2018-03 that provides accounting guidance on the Repatriation Transition Tax, the ATM Credit and the Global Intangible Low-Taxed Income Tax. See the summary of the SAP Working Group for additional discussion.	August 4, 2018
SSAP 1 and Appendix-001 – Alignment of Investment Reporting Schedules (#2018-16)	Adopted	The working group adopted revisions to Appendix 001, which significantly reformats the Summary Investment Schedule to provide for cross-checks and less manual allocations to investment categories.	January 1, 2019
SSAP 21 – Structured Settlements (#2018-17)	Exposed	The working group exposed for comment proposed accounting for structured settlements acquired as investments for which the insurer is not the owner of a corresponding annuity. The proposal would require Schedule BA classification of the invested asset and would initially be recorded at cost.	TBD
SSAPs 2, 26R, 43R & 86 – Structured Notes (#2018-18)	Exposed	This significant new project exposed by the working group proposes that structured notes (except for mortgage-referenced securities), for which contractual principal amounts are at risk for other reasons than failure of the borrower to repay, should be classified and accounted for as derivatives under SSAP 86.	TBD

Appendix A

SSAP 43R – Elimination of the MFE Process (#2018-19)	Exposed	The regulators are asking for comments related to the VOS Task Force proposal to eliminate the modified filing exempt process for non-modeled SSAP 43R securities. See the summary of the VOSTF for additional discussion.	January 1, 2019
SSAPs 15 & 25 – Forgiveness of Related Party Debt (#2018-20)	Exposed	This proposal suggests additional guidance for related party debt forgiveness, including dividend vs income statement write off and the related issue of intercompany expense recognition for service transaction liabilities that are not paid.	TBD
SSAP 72 – Return of Capital (#2018-21)	Exposed	The working group exposed for comment proposed guidance to distinguish whether distributions to shareholders are dividends or return of capital. The guidance appears to reflect industry practice that dividends must represent undistributed earnings of the investee.	TBD
SSAP 37 – Acquired Mortgage Loans (#2018-22)	Exposed	This exposure would modify footnote 2b of SSAP 37 related to participation agreements to exclude ownership interests in a pool/fund of mortgages as SSAP 37 Schedule B mortgage loans.	TBD
SSAP 68 – Statutory Mergers (#2018-23)	Exposed	The working group exposed for comment revisions to SSAP 68 to clarify that combinations of entities that include insurance companies in which no new equity is issued should be accounting for as a statutory merger with the prior periods restated. This would include parent and subsidiary mergers.	TBD
SSAP 25R – ASU 2018-01 (#2018-25)	Exposed	The regulators exposed rejection of ASU 2018-01, Leases-Land Easement Practical Expedient for Transition to Topic 842.	November 2018
SSAPs 97 and 48 – Clarification to Loss Tracking (#2018-26 and #2018-27)	Exposed	As a result of the discussion to adopt the SCA cumulative loss tracking disclosure (#2018-09), the working group decided that clarification as to when an SCA valuation should be negative (versus floored at zero) is necessary and has proposed revisions to par. 13(e) of SSAP 97. In addition the working group is proposing the loss tracking disclosure for SSAP 48 entities and the same clarification to the "negative versus zero" valuation guidance in SSAP 48.	
SSAPs 51, 52, and 61R – Liquidity Disclosures (#2018-28)	Exposed	The working group exposed for comments proposed new disclosures related to life insurance and variable annuity liquidity risks. See the summary of the Blanks Working Group summary for additional discussion.	December 31, 2019
Appendix A-820 – Consistency with Standard Valuation Law (#2018-29)	Exposed	To correct an inconsistency between the Minimum Life and Annuity Reserve Standard included in the APP Manual and the Standard Valuation Law, the working group proposed deletion of the phrase "good and sufficient" from Appendix A-820.	TBD

Appendix B

This chart summarizes action on other proposals of the RBC Working Groups since the 2018 Spring National Meeting, i.e. those not discussed on pages 5-6 of this Newsletter. The detail of all proposals adopted for 2018 RBC are posted to the Capital Adequacy Task Force's webpage (under Related Documents).

RBC Formula	Action taken/discussion	Effective Date/ Proposed Effective Date
All formulas		
Operational Risk Charge instructions (2017-16-O)	After adoption of the 3% add-on factor to reflect operational risk for 2018 RBC filings (2017-13-O), the Operational Risk Subgroup **adopted** the revised instructions in April with final adoption by the Capital Adequacy Task Force during its April 30 meeting.	2018 RBC Filings
Remove Unaffiliated Common Stock for MMMFs (2017-07-CA)	The Capital Adequacy Task Force **adopted** a proposal to remove the common stock charge for money market mutual funds for all formulas as these investments are now classified as cash equivalents.	2018 RBC Filings
Stop loss interrogatories (2018-01-CA)	The Capital Adequacy Task Force **adopted** the revised interrogatories which will gather information (via an electronic only table) to validate the revisions to the stop loss factors adopted in 2017.	2018 RBC Filings
Medicare Part D Terms (2018-03-CA)	The Capital Adequacy Task Force **adopted** for all RBC formulas deletion of Medicare Part D definitions from Appendix 2, which now refers users to INT 05-05, Accounting for Revenue under Medicare Part D Coverage.	2018 RBC Filings
Renaming of Affiliate Risk (2018-05-CA)	The Capital Adequacy Task Force **adopted** a proposal for all formulas to rename the "asset risk" (C0, R0 and H0) "insurance affiliates and miscellaneous other" risk.	2019 RBC Filings
Broker receivables (2018-09)	The Capital Adequacy Task Force **adopted** revised RBC factors for broker receivables for all formulas based on a weighted average calculation of bonds, common, preferred and hybrid stock investments.	2018 RBC Filings
P/C RBC		
Internal Modeling (2016-12-CR)	The Catastrophe Risk Subgroup **adopted** a proposal to allow internally developed catastrophe models (in addition to the six approved third party vendor models) when the insurer uses the same internal model for catastrophe risk management and the domiciliary regulator has approved its use. The CADTF also approved the proposal.	2019 RBC Filings

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PR027 Interrogatory Instruction (2018-08-CR)	The Capital Adequacy Task Force **adopted** a clarification to the P/C RBC instructions that all filers must complete this interrogatory, which supports the exemption from filing the catastrophe risk charge.	2018 RBC Filings
PR026 Exemption (2018-10-P)	The Capital Adequacy Task Force **adopted** the P/C RBC Working Group proposal to exempt entities with less than 5% of A&H premiums from the the Federal ACA Risk Adjustment Sensitivity Test.	2018 RBC Filings
PR017 and PR018 Factor Updates (2018-11-P)	The Capital Adequacy Task Force **adopted** the annual update to P/C line 1 underwriting factors for premiums and reserves.	2018 RBC Filings
Health RBC		
Stand-Alone Medicare Part D Instructions (2018-04-H)	The Capital Adequacy Task Force **adopted** additional language in the instructions for Lines 1 and 6 on page XR012 that beneficiary premium and incurred claims for stand-alone Medicare Part D coverage should be excluded.	2018 RBC Filings
Business Risk (2018-06-H)	The Capital Adequacy Task Force **adopted** additional language in the instructions for Lines 8 and 9 on page XR021 to include ASC and ASO broker commissions.	2018 RBC Filings
All Other Low Income Housing Tax Credit factor (2018-07-H)	The Capital Adequacy Task Force **adopted** a correction to a factor error, updating the factor from .015 to .15 to align with the intended factor, as well as the P/C and Life factors.	2018 RBC Filings
Correction of Bond and Preferred Stock Descriptions (2018-12-H)	The Capital Adequacy Task Force **adopted** revisions to the asset concentration XR011 page to correct the references for bonds and preferred stock; all bonds, both affiliated and unaffiliated are captured on XR011 while only unaffiliated preferred stock are summarized.	2019 RBC Filings

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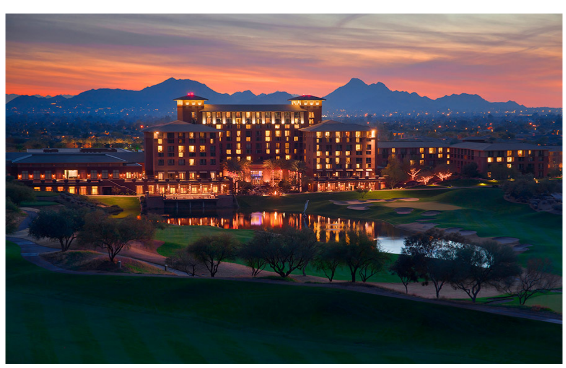

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