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"The Changing Role of the Examiner and Cybersecurity Risk in the Financial Services Industry"

True or False Questions — Submit Answers Online

1. The NAIC has not yet issued but has been working on regulatory principles regarding cybersecurity.
2. The author believes that regardless the "unique risk factors and special needs" encountered by financial services organizations, the examination should focus on ensure cybersecurity is considered as an integral component of corporate governance.
3. One of the areas in evaluating the effectiveness of an insurance company's cybersecurity management program is to how often or regularly the data security control performance is tested and validated.
4. The planning for response to data breach is and should be based upon the understanding that hacking is rare and unlikely for most of the organizations.
5. Insurance companies should have a good understanding and readiness in place of financial exposure as a result of compromised data security.

"Global Insurance Capital Standards"

True or False Questions — Submit Answers Online

1. As early as 1990, a Congressional committee proposed a federal solvency standard for insurers based on its observation of a weak state-based regulatory system.
2. European solvency regulation is based on how much capital the entire group of companies needs, which includes the probability of default based on solvency capital requirements and minimum capital requirements of the group.
3. An increase in higher capital requirements based on international bank – centric standards would likely have less of an effect on smaller U.S. insurers that usually maintain a higher level of capitalization already.
4. China's Risk Oriented Solvency System includes a three pillar framework that is based on the principle of giving the market a decision – making role in resource allocation.

CRE READING PROGRAM QUESTIONS

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(continued)

5. According to an official of the Federal Reserve's Banking Supervision Division, the Fed oversees just under 20% of insurance company assets nationally .

"Catastrophe Bonds"

True or False Questions — Submit Answers Online

1. CAT Bonds are bond stripped treasury securities, similar to TIGRs.
2. Parametric CAT Bonds are triggered based upon estimates of total industry losses.
3. Proceeds received from the sale of a CAT bond are deposited into a trust account to secure the insurer's repayment obligations.
4. CAT Bonds have historically offered higher rates of returns than similarly rated fixed-income securities, and have become more sought after since traditional fixed-income securities are at historically low investment yields.
5. Statutory Accounting guidance is provided in SSAP No. 74 for CAT Bonds with Modeled Loss Triggers.

"NAIC Fall Meeting Notes"

True or False Questions — Submit Answers Online

1. The IT Examination Working Group adopted, for the 2016 Financial Condition Examiners Handbook, new guidance for examiners to address cybersecurity risks.
2. The Financial Condition (E) Committee voted to require audits of TPAs and MGAs by the insurers which utilize them.
3. In a report from the Securities Valuation Office (SVO) to the Valuation of Securities Task Force, the SVO recommended that nonbank financial institutions be allowed to apply to be approved issuers of letters of credit to be used as collateral in reinsurance transactions.
4. Under additional possible revisions being considered by the Financial Regulation Standards and Accreditation Committee to the definition of a "Multi-State Insurer", risk retention groups would no longer be considered multi-state insurers.
5. Under revisions adopted by the Financial Analysis Handbook Working Group, the Group Profile Summary will be the primary deliverable of a holding company analysis and for sharing the results of the holding company analysis among states.

The Changing Role of the Examiner and Cybersecurity Risk in the Financial Services Industry

By **Jan Hertzberg**
Director, Cybersecurity Services, Baker Tilly Virchow Krause LLP

According to the Identity Theft Resource Center (ITRC) (www.idtheftcenter.org), there have been 139 data breaches recorded from January 1 through March 8, 2016, with nearly 1.8 million records exposed. The largest data breach to date was reported by health insurer, Centene Corp., which involved the breach of medical data for over 950,000 customers. The increasing pace, magnitude, and sophistication of data breaches recently has spurred two influential organizations to announce greater scrutiny of cybersecurity risk. The National Association of Insurance Commissioners (NAIC) adopted 12 cybersecurity regulatory principles[1]. The New York State Department of Financial Services (NYDFS) identified core cybersecurity practices that banks and other financial services companies should adopt in a letter to Financial and Banking Information Infrastructure Committee (FBIIC) Members, dated November 9, 2015. These addressed requirements for cybersecurity policies and procedures, third-party service provider management, multi-factor authentication, etc.

While examiners of insurance companies, banks, savings and loans, and credit unions have begun to develop robust examination approaches, tools and techniques, there is still a great deal of confusion amongst field examiners regarding which areas they should focus their efforts. Examiners should have a clear understanding of where they should spend their time to make best use of their very limited resources for maximum effectiveness and efficiency.
While each financial services organization is unique with special needs and risk factors, we believe that there are some key areas upon which all examinations should focus:

Ensure that cybersecurity is considered in the organization's top-down governance programs

Cybersecurity is not purely a technical issue; it is also a business issue. Any business decision (e.g., offering a new service or product to the public, utilizing a third-party service/cloud provider, acquiring a new business) may significantly increase an organization's cybersecurity risk. As a result, cyber-risk needs to be considered in light of corporate strategy, customer service, public relations, and other areas.

In fact, both the NYDFS and the NAIC have said that they expect cybersecurity risks and mitigating steps to be included in Enterprise Risk Management (ERM) programs since it represents an organization-wide, strategic risk.

Evaluate the effectiveness of an organization's cybersecurity management program

The best-prepared organizations are shifting their cybersecurity strategies from focusing on outright prevention, to implementing techniques to quickly detect breaches and limit the damage once a breach has been confirmed.

1 "Principles for Effective Cybersecurity: Insurance Regulatory Guidance", adopted April 2015 by the Cybersecurity Task Force of the NAIC.

There are five main components to consider when evaluating the effectiveness of an insurance company's cybersecurity management program. In each component, organizations need to think about the level of maturity of their processes and controls.

1) Data classification

It is easy for many security departments to turn into the department of "no". This can happen when an organization has not developed a clear understanding of the types and locations of information assets it maintains and, instead, tries to protect all data without regards to their specific risk of disclosure, modification or loss. By developing a robust data classification process, an organization can determine how much effort and cost is required to properly secure the most critical information assets. Once an organization has completed such an initiative, managerial decisions can be made to balance security expenditures with the real business value of the data that the organization is trying to protect.

What is involved in data classification?

Identifying the data that needs to be protected. When properly classified, most organizations find that information varies widely in terms of its risk of disclosure, modification or loss. Some information may be shared with the public, some information should be considered "company internal use" and some information is highly confidential that should be kept highly secure. The amount of financial resources the organization expends to protect information assets, should depend directly on their relative risk to your organization.

Assigning a value to that data. Data has value, either in the amount of competitive advantage the data provides or the hard costs associated with unauthorized disclosure of that data. A successful data classification effort will determine the intrinsic value or risk of the data set. Once an organization determines the true value and risk of the data, it can determine how much to spend to protect it. Additionally, the sensitivity of that data may change over time requiring modification of the initial classification.

Cataloging where critical data exists. There are many places where data may exist (e.g., production databases, backup copies, data warehouses, departmental data stores, test, and development systems). The location becomes crucial in determining how to protect it.

Identifying who has and who should have access to the data. This is critical and may evolve over time. It is entirely possible that a company does not have a full picture of who has access to certain types of data. By identifying who has access to certain data, a company can determine who has a legitimate business need to that data and can further restrict access to the data.

2) Cybersecurity control standards and implementation

Most of us are greatly familiar with general computer controls, which include the IT controls tested during a financial examination or a financial statement audit, but real cybersecurity controls go beyond simple change management and user access reviews.

Hackers aren't filling out user access request forms or submitting change requests, so how does the organization make sure their control environment is prepared to deal with unknown and unseen threats? There are numerous cybersecurity control frameworks organizations can implement. Below are some of the most common frameworks:

National Institute of Standards and Technology (NIST) Framework for Improving Critical Infrastructure Cybersecurity	Mandated by President Obama's Executive Order which was signed on February 12, 2013, this framework unifies many leading control standards, including NIST SP 800-53 and International Standardization Organization (ISO) 27000 Series, into a comprehensive framework for how organizations can improve the security of critical infrastructure. At the core of the framework are control categories within the cybersecurity lifecycle: identify, protect, detect, respond, and recover. Control activity details can be found in the informative references associated with each control category.
Security and Privacy Controls for Federal Information Systems and Organizations (NIST 800-53)	One of the most comprehensive, this standard for security controls is used by organizations doing business with the United States government. Categorized in terms of system impact, its control catalog specifies control baselines for high, moderate, and low impact systems.
ISO 27001	This international standard defines "requirements for establishing, implementing, maintaining, and continually improving an Information Security Management System (ISMS)." The ISO standard sets out the process that an organization should follow when managing information security. Annex A of the standard provides detailed control objectives and controls for information security. The ISO 27001 certification only verifies the information security management system; it does not provide assurance on the implementation of controls specified within Annex A.

SANS Critical Security Controls	The SANS Institute prioritizes security functions with an emphasis on "what works" and defines the top twenty control areas for enhancing cybersecurity. Of the standards outlined here, this is aimed at a more technical audience. Each of the twenty control areas includes more than100 implementation activities organized into "quick win," "visibility/attribution," "configuration/hygiene," and "advanced" categories. For organizations just starting to formalize a cybersecurity management program, the "quick win" controls throughout the standard are a great place to begin.

3) Regular verification of security control performance

Most leading cybersecurity control frameworks include verification controls, which are a vital part of the process of managing cybersecurity. Periodically, organizations should evaluate their cybersecurity controls to obtain assurance over control design and operating effectiveness. We often see organizations with internal audit departments that focus extensively on internal controls over financial reporting. Evaluating cybersecurity controls (through a combination of control testing and penetration testing) is also a great way for internal audit departments to continue to add value by enhancing the overall security posture of the organization.

4) Breach preparedness planning and testing

Based on the premise that cybersecurity professionals now expect their organizations to be hacked, it logically follows that the organizations should have breach response procedures in place. Breach preparedness begins with defining the activities an organization should follow when invoking the plan. Specifically related to cybersecurity incidents and active breach scenarios, a response plan includes critical activities like:

Identifying who to notify internally. Depending on the dataset compromised, it is important to understand who to notify when there is a breach. Certain business processes and contingency plans need to be put in place; process owners need to be directly involved in developing them.

Establishing a response team. Certainly, the IT department will be closely involved with the response. In addition, the general counsel, chief risk officer, chief financial officer and/or the chief audit executive will also have a key role for risk management and fiduciary responsibilities. Other stakeholders (e.g., regulatory affairs, vendor management, and human resources) may need to be involved.

Implementing monitoring protocols to track intruder activity. Unplugging the compromised system from the network may not be an appropriate strategy following a breach. The organization may need to observe intruder behavior first hand to understand the extent of the breach. Additionally, law enforcement officials may need to monitor

activity in their attempts to track the intruder. Unplugging the system alerts the intruder that his/her activity has been detected and will give the intruder time to cover their tracks.

Establishing egress prevention. Once an attacker is in your network, he may remain there for a while looking for higher value targets. Preventing critical data from leaving the organization's network without letting the attacker know he is being watched is important.

Notifying proper legal authorities. Make sure the organization knows who to call when a breach occurs. Knowing who to contact when a breach is suspected can help shorten your overall response time.

Determining the extent of the compromise. Understanding what data has been compromised is critical to managing the breach response process. The type and extent of compromised data may directly affect an organization's notification, response, disclosure, and any potential penalties. If an organization has already classified and inventoried its information assets ahead of time, this process may be made much less time-consuming.

Coordinating with legal counsel and insurance carriers. Depending on the type and extent of breach, legal assistance may be needed to file the necessary notices and help manage any legal consequences of the breach. To the extent that the organization is covered by a cyber-liability policy, notifying the carrier is a necessary step to prepare for the claim.

Analyzing root-cause and implementing security remediation. During the response, it is critical to identify how the breach occurred and then implement a remediation plan to address the vulnerabilities ensuring a similar breach cannot happen again.

Practice, practice, practice. As with disaster recovery and business continuity planning, proficiency with the plan comes with practice, so organizations should periodically conduct tabletop tests of the breach response plan to make sure stakeholders know what to do in the event of an actual breach.

5) Risk acceptance and risk transfer

As recent high-profile breaches demonstrate, even with robust security processes in place, organizations can suffer a breach. When security measures fail, financial impacts (e.g., credit monitoring for affected customers, increased transaction processing costs, or fines assessed by regulatory agencies) may occur. Organizations must understand their financial exposure relative to a compromised dataset.

At that point, the organization can evaluate the overall effectiveness of its cybersecurity process and decide whether to accept that risk or transfer that risk through a cyber-liability policy. Insurance carriers are quickly evolving

cyber policies and coverage. Underwriters are taking closer looks at how companies assess and manage their cybersecurity risks. By implementing effective cybersecurity management programs, organizations may be able to receive reduced premiums or more favorable policy limits.

Good business sense

Cybersecurity management is a complex topic that requires substantial organizational attention in order to be effective. It involves all areas of the organization – finance, human resources, operations, public relations, sales, etc. By working collaboratively across an organization, it is possible to more effectively manage cybersecurity risks in order to reduce the likelihood of an exposure, limit the extent and impact of an exposure, and be prepared to recover from the damages of a breach.

As cybersecurity risk becomes an even greater threat to the operations of financial services organizations over time, it will be up to examiners to assess the strength of cybersecurity processes and controls. By focusing their efforts on these key risk areas, examiners can make more efficient and effective use of their resources.

About the Author

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Jan Hertzberg is Baker Tilly's National Cybersecurity Services Director, with more than thirty years of experience in providing IT audit, risk, cybersecurity, and privacy compliance services. His clients include a range of financial services companies including banks, health/property and casualty insurance companies, credit unions, exchanges, asset managers and clearinghouses. Jan has extensive experience in identifying and evaluating cybersecurity process, control and technology risks by utilizing a variety of cybersecurity and industry frameworks (including NIST Cybersecurity Framework, NIST 800-53, FFIEC, ISO and GAPP). He has conducted NIST Cybersecurity Framework training for state examiners that focus on the financial services sector, including banks and insurance companies. He has also provided co-sourced cybersecurity examination services on behalf of state insurance examiner organizations.

GLOBAL INSURANCE CAPITAL STANDARDS

Origin, Perspectives and Impact on U.S. Markets

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EXECUTIVE SUMMARY

The United States insurance regulatory system has been in existence for more than 150 years. According to the National Association of Insurance Commissioners (NAIC), the U.S. regulatory mission is "to protect the interests of the policyholder and those who rely on the insurance coverage provided to the policyholder first and foremost, while also facilitating an effective and efficient market place for insurance products."[1]

Solvency is the cornerstone of insurance regulation, providing crucial safeguards for policyholders and for the economy. This I.I.I. white paper explores efforts related to solvency regulation that could have far-reaching and critical implications for the entire global insurance system—both internationally active insurers and those whose operations are distinctly local.[2] Beginning with an overview of the history of key changes in the United States and European solvency regimes, the paper focuses on the current initiative to build a common framework of capital requirements and prudential capital standards for internationally active and global systemically risky insurance groups since, in theory, the failure of a systemically risky insurer can cause significant dislocation in the global financial system. The paper also describes the perspectives of various stakeholder groups and the impact of this massive undertaking on different markets.

In the United States, the standards for solvency regulation, including risk-based capital requirements, are established by the NAIC and vary by state. In Europe and much of the rest of the world, solvency regulation is done on a national level.

U.S. and European regulators also have different approaches to regulating solvency. Most large insurers are groups, made up of several individual insurance companies.[3] European regulators focus on group solvency; U.S. regulators focus on each individual company.

The two approaches operated effectively in parallel for decades; however, the 2007–2009 financial crisis upset that order, due to the following actions.

- The federal government established a Federal Insurance Office (FIO) to monitor the industry and coordinate with the states on international matters.
- An international group of regulators began developing global standards for large insurance groups with significant foreign operations.

As a result, today large, complex U.S. insurers face mounting pressure to conform to global rules and capital standards. Smaller U.S. insurers feel threatened as well. A transformation of this magnitude would represent a major shift in the regulation of insurance in this country.

While some believe that "one size fits all" global capital requirements are necessary to avoid another meltdown, others strenuously disagree. Opponents claim that:

- The current U.S. regime is well established and already has sufficient regulatory financial oversight, risk-based capital requirements and other backstops to evaluate the capital adequacy of insurers.

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- The European focus on group solvency offers policyholders less protection than the U.S. approach, which focuses on the individual entity. Since group capital is fungible—i.e., it can move freely from entity to entity within the group—the solvency of any firm may be at risk. The European Union (EU) focuses on protecting shareholders, bondholders and other risk takers as well as policyholders, meaning that European regulators' primary emphasis is not on the welfare of consumers and the ability to pay claims. Since higher global requirements may not even prevent an insurer's failure, consolidated group-wide supervision should supplement—not replace—the legal-entity approach in the United States.

- Rigid, formulaic global capital standards that apply to both insurance and non-insurance risks, based on accounting rules that differ from U.S. rules, are not compatible with this country's insurance markets. Opponents prefer a flexible "outcomes-based" approach that allows for different assessments and valuations from country to country–as long as similar, comparable outcomes result.

- The significant differences between U.S. and European systems mean it is critical that regulators understand those differences. They should recognize the strengths and best practices of each and harmonize existing regimes. A global capital standard should be just one tool for assessing whether capital is adequate, not a requirement.

- Higher capital requirements would likely impose additional and unnecessary costs on insurers that could slow the industry's growth and reduce the availability of coverage.

The process of creating a uniform risk-based solvency regime is complex and time-consuming. Some believe international regulators have been moving too aggressively toward adopting new rules before understanding all of their implications.

The Federal Reserve Board and FIO generally support the concept of global capital standards, but they are clear that such standards will not be imposed on U.S. insurers by foreign regulators. Higher capital requirements will be adopted only by U.S. authorities following applicable rulemaking procedures, and only after rules are deemed compatible with state laws and appropriate for U.S. insurers and markets.

Separate from the global activity, U.S. regulators are exploring the development of group wide standards for internationally active insurers, and these will likely be created. Given that more rigid requirements—whether imported from Europe or home-grown—may trickle down to smaller, non-systemically risky insurers and influence regulatory approaches in different local jurisdictions, it is important for all insurers to closely monitor developments.

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THE PURPOSE OF INSURANCE SOLVENCY REGULATION

The primary goal of insurance regulators is to make sure there is sufficient capital for insurers to operate and meet their obligations to policyholders and other claimants. Solvency regulation in the United States is accomplished by various means. To conduct business in a state, insurers must meet the state's minimum capital and surplus standards. These standards vary by type of insurer (stock versus mutual) and by broad type of insurance (life versus non-life). The types and amounts of investments that insurers make (e.g., medium- and long-term government and high-grade corporate bonds) are also regulated. Furthermore, state insurance departments conduct periodic audits of companies' financial statements (usually every three to five years) and other examinations to verify that companies are complying with statutes and prudent managerial practices.

Another important feature of the U.S. regulatory structure is the provision for the effective resolution of insurer failures and claim payments against insolvent insurers. Each state has a guaranty fund system that covers claims if an insurer is unable to do so. Funds are available through assessments of all remaining insurers based on a fixed percentage (about 2 percent) of their net direct written premiums.[4]

Since the late 19th Century, U.S. solvency regulation has been at the state level. (Some aspects of insurance do require uniformity and are now regulated under a national system.) After a brief period when the Supreme Court decided that the insurance industry could be regulated by federal law, state regulation has been firmly cemented due to the passage of the McCarran-Ferguson Act of 1945.[5] Although proposals to fully replace state regulation with federal regulation have been raised from time to time, there has never been a consensus to pass such legislation.

KEY CHANGES IN INSURANCE SOLVENCY REGULATION: 1970s–2000s

Regulation is not static – the emergence of solvency problems, new types of risks and tort liabilities, technological advances and more divergent consumer needs are just some of the challenges that have confronted regulators and insurers. To keep up, regulatory systems have had to evolve as well.

Solvency Regulation in the United States

The following provides key activities related to insurance solvency regulation and capital requirements in the United States from the 1970s to the 2000s:

- In the early 1970s, as part of its Early Warning System, the NAIC began examining financial ratios from insurers' Annual Statements to help identify potentially troubled companies. The ratios test a company's premiums, surplus, profitability, liquidity and reserves. Weak scores helped regulators target companies that may require regulatory attention. In 1979 the ratios became part of the NAIC's Insurance Regulatory Information System, often known by the acronym IRIS. These ratios are part of the NAIC's portfolio of Financial Analysis Solvency Tools (FAST).

- In the 1980s, the insolvencies of four large property/casualty (P/C) insurers caused by the liability crisis together with the U.S. savings and loan debacle prompted a Congressional subcommittee investigation that culminated in a 1990 report, “Failed Promises: Insurance Company Insolvencies.”[6] Reasons for the insolvencies, according to the report, included insurer fraud and mismanagement combined with a weak state-based regulatory system due to inadequate reporting of loss reserves, a lack of coordination among state regulators and insufficient financial examinations of insurers. As a solution, the report proposed to incorporate a federal solvency standard.

- States responded by adopting a series of NAIC model bills in the late 1980s. Some bills required greater transparency in insurers’ financial statements, independent CPA audits and opinions of loss reserves by qualified actuaries. In 1989, the NAIC implemented Financial Regulation Standards that included, among other items, base-line regulatory practices and procedures designed to supplement the enforcement of financial solvency laws.[7]

- In 1990, the NAIC adopted a formal accreditation program to promote the effective solvency regulation of insurers, particularly multi-state writers.[8] Subsequent enhancements were made after the General Accounting (now Accountability) Office (GAO) criticized the program for having loosely interpreted standards, a lack of focus on implementing required practices and questionable accreditation decisions.[9]

- During the 1990s, the NAIC established separate risk-based capital (RBC) requirements[10] for U.S. P/C and life and health insurers, replacing the earlier fixed capital and surplus minimums that were criticized for being too low. Rather than being target/optimum levels of capital, the new standards were intended to be minimum levels of capital needed to support an insurer’s overall business operations based on its size and risk profile and to avoid regulatory action. RBC models are considered more accurate than earlier minimum capital and surplus requirements. They are used in conjunction with other early warning indicators (e.g., on-site examinations, IRIS ratios and FAST scores).

- In early 2000, NAIC members signed a “Statement of Intent: The Future of Insurance Regulation,” in which they pledged “to modernize insurance regulation to meet the realities of the new financial services marketplace” and “to work cooperatively with all our partners … to facilitate and enhance this new and evolving market place as we begin the 21st Century.”[11]

- In the late 2000s, as pressures leading toward the global financial crisis were building, the NAIC started another move to improve regulatory oversight. One of its key programs, launched in 2008, was the Solvency Modernization Initiative (SMI). It had two principal components: (1) the Own Risk and Solvency Assessment (ORSA); and (2) the Model Holding Company Act.

(1) ORSA[12] requires insurers and insurance groups to conduct a self-assessment of their risk management and capital adequacy, examining all material and relevant risks—current and future—under normal conditions and under severe stress. The two primary goals of ORSA are to: (a) foster an effective level of enterprise risk management (ERM) for all insurers; and (b) provide a group-level perspective on risk and capital as a supplement to the existing legal entity view. It is a continuously evolving process that allows insurers to determine their own approach to self-evaluation. Beginning in 2015, insurers must submit to state regulators annual ORSA Summary Reports regarding their ERM capital management process.

(2) The Model Holding Company Act is designed to improve group supervision, ensuring that regulators of global firms analyze risk concentrations across the group and between affiliates, regardless of jurisdiction. Under this model law, state regulators are given clear authority to have direct supervision over insurance companies within a holding company structure. They can participate in "supervisory colleges,"[13] a collection of regulators that oversee a group and its individual insurance legal entities. Regulators receive additional tools to evaluate insurer risks, as well as greater access to a group's books and records. The act requires holding companies to disclose to regulators information about changes under their control and all of their financial activities, including future business plans of insurance and non-insurance affiliates.

Solvency Regulation in Europe

Across the Atlantic, the European Insurance and Occupational Pensions Authority (EIOPA) has been striving to modernize capital regulation for decades. [14] The major piece of insurance financial regulation—the Solvency Directive—is largely based on Europe's solvency scheme from the 1970s. In light of the close relationship between European insurers and banks, the Solvency framework focusing on insurance groups and holding companies is analogous to the Basel Capital Accord applicable to banks.[15]

The Solvency I Directive to assess the risk profile of insurance firms in the European Union was adopted by EIOPA in 2002 and went into effect two years later. Solvency I was inherently weak. It dealt primarily with minimum capital standards that did not reflect the true risk of insurers; it did not focus on risk management and governance within firms. It was replaced by the Solvency II Directive in 2009.

Solvency II serves as the basis for much of the ongoing capital standards work currently performed by the International Association of Insurance Supervisors (IAIS). The IAIS is a voluntary standard-setting body established in 1994 to promote effective and globally consistent supervision of the insurance industry.[16] It advises international leaders on insurance matters and collaborates with the Organization for Economic Co-operation and Development (OECD) and other international supervisory associations.

Solvency II takes a risk-based approach to prudential regulation. It is intended to harmonize ERM standards and implement complex capital standards. The capital standards are based on economic principles for the valuation of assets and liabilities. Solvency II regulates an insurer's health three ways:

(1) It sets rules for sophisticated models that develop a mathematical estimate of how much capital a company needs.

(2) It sets rules for risk management and governance.

(3) It sets rules for transparency and disclosure, so the free market can assess an insurer's health and become a de facto regulator.

A key feature of Solvency II is the recognition of the free flow of capital (i.e., fungibility) across individual insurers in an insurance group; hence, members of the group are financially responsible for each other.

Included in the Solvency II framework is an "equivalence" provision whereby EU insurers can use local rules to report on their operations in third countries, while third country insurers are able to operate in the EU without complying with all of its rules. The "equivalence" evaluation is based on three distinct areas: (1) solvency or group capital calculation, for EU insurers operating in a third country; (2) group supervision, for third country insurers active in the EU; and (3) reinsurance, for third country reinsurers active in the EU.[17]

The Solvency II regime is set to begin on January 1, 2016.[18]

THE GLOBAL FINANCIAL CRISIS USHERS IN A NEW ERA

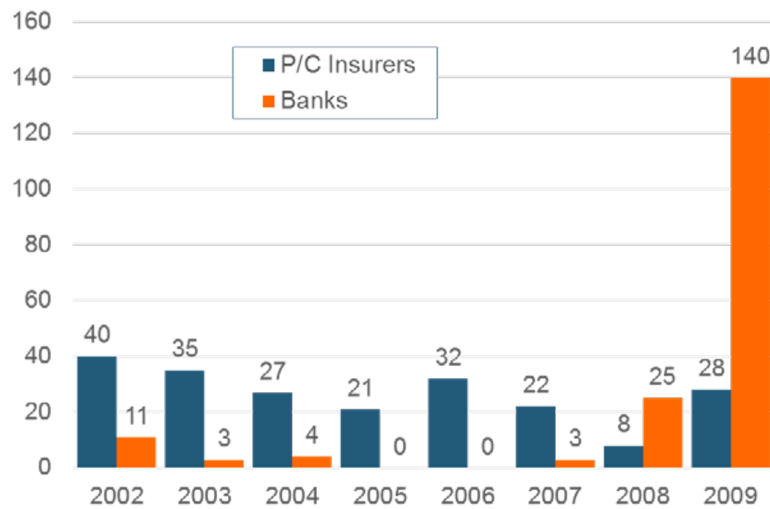
The 2007–2009 global financial crisis, caused in part by rating agencies that erroneously overrated the creditworthiness of mortgage-backed securities, raised concerns about the effectiveness of financial regulation worldwide. This event is viewed primarily as a banking crisis. Banks have higher risk because they are exposed to greater asset volatility and are more susceptible to disruptions in the credit market. On the other hand, the insolvency of insurers as a whole, especially in the United States, did not appear to be threatened; insurers fared better than banks because they have less debt and more equity with which to finance their assets.

According to the GAO, "The effects of the financial crisis on insurers and policyholders were generally limited, with a few exceptions… Actions by state and federal regulators and the National Association of Insurance Commissioners (NAIC), among other factors, helped limit the effects of the crisis." During 2007–2009, there were 34 P/C receiverships and 24 P/C liquidations out of 3,000 active P/C insurers in the U.S.; the average assets of P/C companies in liquidation was $151.4 million. It should be noted that some regulators and insurance industry representatives interviewed by the GAO stated that failures that occurred during and immediately after the

financial crisis were generally not related directly to the crisis.[19] In contrast, out of roughly 8,300 commercial banks and savings institutions insured by the Federal Deposit Insurance Corporation (FDIC), there were 168 failures during this same period; their failed assets totaled $544.3 billion (as of December 31, 2009).[20]

Figure 1 shows that the number of property/casualty failures remained did not increase significantly during the 2008–2009 financial crisis. The 28 failures in 2009 was just slightly above the average of 26 failures the preceding seven years. Banks had fewer failures in the years leading up to the crisis but failures rose significantly in the crisis years.

Fig. 1
NO. OF FAILED FINANCIAL INSTITUTIONS, 2002-2009*



*Includes both insurers in liquidation and in receivership
Sources: Government Accountability Office, Federal Deposit Insurance Corporation, Insurance Information Institute.

In response to the crisis, G20 leaders created the Financial Stability Board (FSB) in 2009. Succeeding the Financial Stability Forum, the FSB is an international body that monitors and evaluates vulnerabilities affecting the global financial system and proposes actions needed to address them. FSB members include international financial institutions and standard-setting, regulatory, supervisory and central bank bodies. Like the IAIS, the FSB is based in Switzerland. The U.S. Treasury Department, Federal Reserve Board (the Fed) and Securities Exchange Commission represent the United States on the FSB. No U.S. state insurance regulators serve or are represented on the FSB. The only insurance-related member of the FSB is the IAIS, which falls under FSB's direction.

Introducing the Dodd-Frank Act

In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) became law "to promote the financial stability of the United States by improving accountability and transparency in the financial system."[21] Dodd-Frank made sweeping changes, imposing stricter rules and oversight on large bank holding companies and other companies whose demise could threaten the nation's economy.

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Since the U.S. insurance markets had remained competitive and financially sound during the financial crisis, Dodd-Frank preserved the role of the state regulatory system. It did establish the Federal Insurance Office (FIO) and placed it in the Treasury Department. The FIO is not authorized to regulate insurers; its functions include but are not limited to:

- Monitoring all aspects of the insurance industry.
- Coordinating federal efforts and developing federal policy on prudential aspects of international insurance matters.
- Consulting with state insurance regulators on insurance matters of international importance. The FIO represents the Treasury Department and the United States at the IAIS and in other bi-lateral and multi-lateral international insurance matters.

Dodd-Frank also established a Federal Stability Oversight Council (FSOC), accountable to Congress. The FSOC identifies risks to the financial stability of the United States that could arise during financial distress or when large financial firms fail—whether they are banks, nonbank financial companies or organizations outside the financial services marketplace. To help minimize these risks, the FSOC has the authority to designate an entity as a systemically important financial institution. Such a company is usually referred to as a SIFI and may become subject to stricter oversight by both the FSOC and the Fed, the company may also be required to put up more capital as a hedge against the risk it presents.[22]

Under Dodd-Frank, it was not clear whether banking capital rules applied to insurers since bank regulation focuses on groups and insurance regulation focuses on legal entities. To clarify the matter, the Insurance Capital Standards Clarification Act of 2014 amended Dodd-Frank to confirm the distinctions between banking and insurance capital rules. It guarantees that institutions engaging in insurance are not held to the same capital standards as traditional banks. The Fed now has greater authority over insurance holding companies[23] with thrift subsidiaries and can apply insurance-based capital requirements to these entities.

THE INTERNATIONAL SOLVENCY REGULATORY LANDSCAPE OF TODAY

Until the late-2000s, it was generally believed that insurance regulatory changes taking place in Europe were not germane to other markets. However, the financial crisis and the growing presence of both the FSB (a bank regulator) and the IAIS have uprooted the landscape. Besides the U.S. and EU, other countries have been modernizing their insurance solvency regulations as well. Appendix I provides a brief overview of the recent reform efforts in China, certain Latin American nations and South Korea.

Under the direction of the FSB, the role of the IAIS has changed dramatically. The organization had been a forum for international regulators to cooperate, communicate and discuss best practices. Now it is one of the main drivers supporting and working towards global regulatory convergence.

Since 2013, the IAIS has been developing a global standard on how much capital an insurer should hold. The standard would be based on the amount of risk an insurer bears and would arrive at essentially the same answer regardless of where the insurer was located or who regulated it. The challenge has been reconciling differences among international regulatory systems.

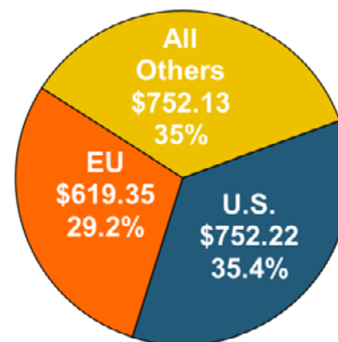
General Differences in the U.S. and EU Solvency Regimes

Figure 2 shows the United States and the EU represent two of the world's largest insurance markets, generating nearly two-thirds of the world's P/C premiums in 2014.

The regulatory systems of the United States and EU differ vastly in terms of philosophy, structure and operations, and this extends to requirements on how much capital to hold.

U.S. regulators have capital requirements for individual insurance companies but do not have requirements at the group level. U.S. insurance groups can have many companies scattered across several states. U.S. regulators focus on individual companies, worried that the free flow of capital across a group could jeopardize individual companies within a group.

Fig. 2
DISTRIBUTION OF GLOBAL NON-LIFE INSURANCE PREMIUMS, 2014
($ Billions)



Source: Swiss Re, *sigma*, No. 4/2015.

The U.S. supervisory system relies on a free market approach; for capital requirements it allows greater management discretion. The U.S. method of measuring whether capital is adequate is called Risk Based Capital (RBC). The minimum amount of capital each insurer needs is based on a formula that takes into account the amount of insurance the company writes, the lines of business it writes, the assets it invests in and other measures. The data used is auditable, much of it from the company's Annual Statement. The result is a risk-based capital amount—in theory the absolute least amount of capital an insurer needs. If an insurer's capital dwindles, regulators have the opportunity to intercede. The closer the actual capital gets to the risk-based minimum, the more powerful the intervention can be.[24]

In addition, state regulators conduct periodic regulatory financial examinations and analysis.[25] If an insurer falters, each state, and the District of Columbia, has an effective system to rehabilitate the company or, if necessary, liquidate it—a system that has been in place for decades. [26] This important feature safeguards policyholders and claimants if a company has insufficient funds to pay claims.

In contrast, European solvency regulation (for both insurers and banks) is regionally based with a primary focus at the group level. It emphasizes a consolidated capital standard that helps to ensure that a financial entity maintains adequate capital to support its group-wide activities, both insurance and non-insurance (mostly banking). Proponents of Solvency II claim that by using this approach, capital is better aligned with an entity's true economic risks.

The standards and formulas calculate how much capital a group needs, with a prescribed confidence level for a period of time, a concept known as value-at-risk. There are two key measures calculated. The solvency capital requirement is the amount a company needs so that the probability of default is remote—less than one-in-200.[27] Regulators can intervene when the threshold is breached. The minimum capital requirement is the amount a company needs so that the probability of default in the next year is less than 15 percent. Breaching the minimum can cost the insurer its authorization to write business.[28] The calculation requires data more detailed than what is regularly audited and verified. The result is a prudential capital requirement higher than is mandated by the United States.

No capital standard is foolproof.[29] Twelve of the 30 countries in the EU and European Economic Area have insurance guarantee mechanisms. These plans, however, vary significantly in design and are not harmonized at the EU level. As such, according to a European Commission white paper, the guarantee funds in Europe hinder "effective and equal consumer protection," which "may lead to a loss of consumer confidence in the relevant markets and may ultimately put at risk market stability."[30]

European regulation follows the premise that it should protect bond holders, equity holders and other claimants in addition to policyholders.

To summarize: The United States scrutinizes individual entities using capital standards and regular in-depth exams—a bottom-up approach designed to protect policyholders and claimants. The minimum amount of capital an entity needs is calculated using auditable data and regulators intervene if capital approaches the minimum. A coordinated set of state guaranty funds act as a backstop.

In the EU, Solvency II applies a strict set of rules to groups of insurers under the same corporate umbrella—a top-down approach designed to protect policyholders, bond holders, equity owners and other claimants. The amount of capital a group needs is calculated using data both auditable and beyond audit. The result is typically higher than the U.S. calculation. Some nations have guaranty funds as a backstop, but it is not a coordinated effort as it is in the United States.

The EU-U.S. Mutual Regulatory Understanding Dialogue Project

In 2012, the "EU-U.S. Mutual Regulatory Understanding Dialogue Project" was formally recognized to build greater mutual trust, understanding and collaboration between European and

U.S. regulators. The project is intended to help the European Commission, EIOPA, NAIC and FIO better appreciate the overall design, function and objectives of key aspects of the two capital regimes and work towards a common goal of regulatory modernization for more effective supervision. Even though the United States was recently granted "provisional equivalence" under Solvency II,[31] U.S. state regulators prefer to work with the EU following this approach of mutual understanding.

The project released a major report in December 2012[32] that compared the regions' insurance supervisory and regulatory schemes in seven areas. These are:

(1) Professional secrecy/confidentiality;

(2) Group supervision;

(3) Solvency and capital requirements;

(4) Reinsurance and collateral requirements;

(5) Supervisory reporting, data collection and analysis and disclosure;

(6) Supervisory peer reviews;

(7) Independent third party reviews and supervisory on-site inspections.

The report was accompanied by a plan that outlines common objectives and initiatives to be pursued over the next five years in each area, an attempt to improve convergence and regulatory compatibility between the EU and the United States. The plan was updated in July 2014.[33] Appendix II summarizes the steps to be taken to achieve the objectives of each of the seven areas.

Fig. 3
THE IAIS REGULATORY FRAMEWORK
(Guidelines for Regulators Worldwide)

	Insurers It Would Apply to	Capital Standard
Insurance Core Principles	All insurance entities and groups	Determined by local regulators
ComFrame	Large international groups	International capital standard
Systemically Important Insurers Framework	Systemically important insurers	International capital standard* plus higher loss absorption

* Systemically important insurers must meet a basic capital requirement while international capital standard is developed.

THE EMERGENCE OF GLOBAL INSURANCE CAPITAL STANDARDS

While the EU and state regulators were addressing their needs, a larger group of regulators was also developing standards to converge insurance regulation worldwide. The international insurance

supervisors group–the IAIS–developed a three-tiered framework of regulation and supervision, summarized in Figure 3:

(1) A set of insurance core principles that are typically referred to by the acronym ICPs.

(2) A common framework for supervising insurance groups that operate internationally, which is usually referred to as ComFrame. Internationally active insurance groups are often referred to as IAIGs.

(3) Methods of handling the largest insurers, whose size and scope mean their struggles could imperil global markets. These insurers are known as global systemically important insurers, or G-SIIs.

Addressing each in order:

Insurance Core Principles - Reflect EU priorities and perspectives, but they have gained acceptance among U.S. regulators. The NAIC describes the principles as a globally accepted framework for the supervision of the insurance sector. They are based heavily on Solvency II's top-down concepts.[34]

As depicted by the NAIC, these principles include "the essential elements that must be present in the supervisory regime in order to promote a financially sound insurance sector and provide an adequate level of policyholder protection. They are applicable to the supervision of all insurers and insurance groups, regardless of their size, international orientation or systemic importance."[35] There are 26 ICPs dealing with issues such as supervisory authority, corporate governance, enterprise risk management for solvency purposes, capital adequacy and group-wide supervision.

Although the core principles are not legally binding, the International Monetary Fund (IMF) and World Bank use them in evaluating a company's insurance operations in their Financial Sector Assessment Program, a review that looks for vulnerabilities in a country's financial system and develops appropriate responses.

The latest U.S. evaluation found, among other results, that insurance supervision has significantly improved in recent years and there is a reasonable level of observance of the core principles. However, they found gaps in risk management requirements and noted that the U.S. insurance regulatory system remains complex and fragmented. The IMF and World Bank also said: "States should have the ability to set group-wide valuation and capital requirements." It recommended that the Federal Reserve Board, the nation's key banking regulator, "should develop *a valuation and capital standard speedily."*[36] At this time, it is unclear how the Fed, NAIC and state regulators will respond.

ComFrame - A project under development since 2010, ComFrame focuses on the effective supervision of large internationally active groups that include at least one sizeable insurance entity.

These are insurers with assets of $50 billion or more, or gross written premiums of $10 billion or more that operate in at least three countries with at least 10 percent of their business conducted in foreign markets.[37] There were about 50 groups in mid-2015,[38] making up about 50 percent of the global insurance market. They do not necessarily present a systemic risk, but the IAIS believes their complex structure warrants more coordinated supervision internationally.

ComFrame complements and expands upon the core principles; its structure contains three modules:

- Scope, including rules on how to identify internationally active insurance groups and the group-wide supervisor and the breadth of supervision.

- The groups themselves, including the quantitative and qualitative requirements that they must meet.

- Supervisors, which includes the process of supervision, highlighting the group-wide supervisor's responsibilities (e.g., enforcement and interaction).

According to the NAIC, ComFrame is the most significant global initiative regarding group supervision.[39] It will include a set of capital standards for the large international insurers, with a more stringent requirement for the systemically important.

Global Systemically Important Insurers - The IAIS is also developing measures to regulate the handful of insurers whose demise could, some believe, threaten the world financial system. These insurers are called global systemically important insurers, or G-SIIs. In July 2013, the IAIS was directed to establish measures to impose on these insurers.[40] Measures include enhanced group supervision, effective resolution of troubled companies and the development of two capital standards: (1) an international capital standard that all internationally active insurance groups will have to hold; and (2) an additional layer of capital that systemically important insurers will have to hold.[41]

The first standard is difficult to develop, so in the short term regulators have created a stopgap, known as the basic capital requirement (BCR), to apply to the systemically important groups. When the international capital standard is developed it will replace the BCR. Systemically important insurers will still need to hold the additional capital as part of the higher loss absorption requirement.

Following is a description of the three standards and their timelines, with details in Figure 4:

- *Step 1:* The basic capital requirement was created to reflect the insurance and non-insurance risks of all group activities of a company designated as systemically important. It was designed to be simple, practical and transparent. It was intended to show a group's

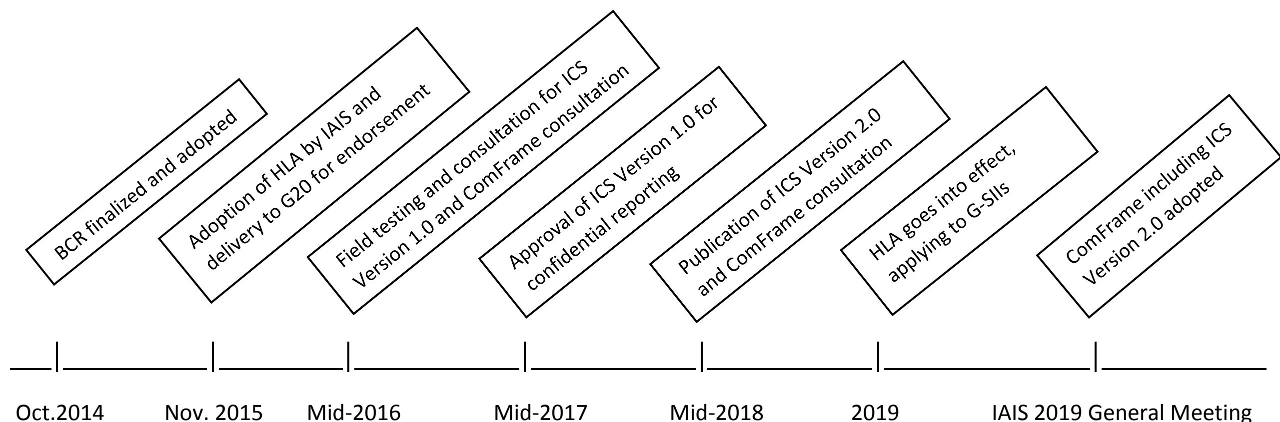
resilience to financial stress and give comparable results from nation to nation. The international supervisors adopted a standard in October 2014. The average BCR is 75 percent of the reported average prescribed capital requirement.[42]

- *Step 2:* The higher loss absorption standard is designed to build on the foundation of the basic requirement. The first public consultation document requesting feedback from stakeholders was released in June 2015. G20 leaders endorsed the HLA standard in November. It is planned to go into effect in 2019.[43]

- *Step 3:* The international capital standard will be more detailed and comprehensive than the basic capital requirement. It will reflect all material risks to which internationally active groups are exposed.

  The target date for adopting ICS Version 1.0 is May/June 2017. ICS Version 2.0 will be a part of ComFrame and adopted in late 2019. ComFrame, including ICS Version 2.0, is now planned to go into effect in early 2020. Then the IAIS will continue working to create a final, single ICS whose completion date is not yet known.[44]

Fig. 4
IAIS TIMETABLE



PERSPECTIVES OF COMFRAME AND GLOBAL INSURANCE CAPITAL STANDARDS

Many are concerned that new foreign regulatory standards could fundamentally alter insurer solvency regulation and product availability in the United States.

Benefits of ComFrame and Global Insurance Capital Standards

Creating an approach to supervise internationally active insurers and developing global risk-based capital standards is not without merit. Proponents claim these standards would:

- Provide an accurate measure of capital and risks and promote financial stability.
- Prevent gaps in regulation that could create global vulnerability and stress in the financial system.
- Provide a level playing field in regulating insurers and quantifying their capital.
- Reduce inefficiency and duplication across jurisdictions and drive down compliance costs.
- Streamline supervisory roles so supervisors make more effective decisions, potentially lowering coverage costs for consumers.
- Limit regulatory arbitrage and jurisdiction shopping; i.e., an insurer would not be tempted to move to another country with more favorable regulations to save costs.
- Encourage competition, new entrants and growth in markets.

U.S. attitudes on the topic vary, even among regulators.

Federal Reserve Board and Federal Insurance Office Perspectives

The Fed generally believes in the use of effective global capital standards for regulating internationally active firms. U.S. insurers entering and expanding into international markets stand to benefit greatly from reasonably consistent global requirements that consider the risks across the entire firm and a consolidated regulatory framework that is strong but pragmatic. The Fed recognizes the importance of consolidated group-wide supervision and capital standards that supplement the legal-entity approach.[45]

Similarly, the FIO agrees that global capital standards will enhance the U.S. regulatory system, but notes the standards must be developed correctly. Testifying before Congress, the FIO expressed concern that developing the higher loss absorption standard—the capital the largest insurers would hold against the systemic risk they present— “represents a significant technical challenge for the IAIS because of the heterogeneity of insurance firms and the variety and complexity of products sold by insurers across the world.” International standards must be compatible with the unique features of the U.S. insurance sector, the FIO says. They should promote effective financial stability and policyholder protection, and foster competition and consumer choice.[46]

Both the Fed and the FIO are adamant that these standards and rules cannot be imposed on U.S. firms by an international body; rather, their adoption will be done through federal and state authorities only, following typical U.S. rulemaking procedures: a transparent process for proposal issuance, solicitation of public comments and rule finalization. The standards should not conflict with U.S. law, according to the Fed and the FIO, and they must accommodate U.S. insurance

markets and individual insurers. Before they are adopted, they must be tested for accuracy, value and impact.

NAIC and U.S. State Regulator Perspectives

Although the NAIC and state regulators favor greater international coordination, they have serious concerns about ComFrame and global capital standards, believing that:[47]

- "One size fits all" global standards are not appropriate in the United States. The unique nature of insurance requires similarly unique models compatible with the insurance business, not other financial sectors. According to a past president of the NAIC, "taking a more homogenous regulatory approach that treats insurers more like banks may actually encourage new risk-taking in the insurance industry."

- Countries differ—sometimes significantly—in how they measure and monitor capital. The differences will make it necessary to consider the usefulness of stress and scenario-based testing, local jurisdictional capital requirements, intra-group transactions and the fungible nature of capital. Another consideration: Inconsistent accounting rules among countries call for the use of different valuation/balance sheets.

- Global capital standards could supersede the U.S. state-based system of regulation for insurance groups—contravening Dodd-Frank—and undermine legal entity capital requirements. The problem: Allowing capital to flow freely from entity to entity within a group could jeopardize the financial strength of one entity. State regulators say flow of capital out of a company should be subject to regulator approval.

- ComFrame should follow an "outcomes based" approach rather than a rigid approach. In other words, instead of following an exact methodology, different assessments and different valuations should be acceptable as long as they result in similar outcomes of capital adequacy. To do otherwise, state regulators warn, could increase costs for U.S. insurers and their customers.

- To avoid duplication, new rules should supplement, not replace, current U.S. capital requirements for legal entities.

- The rules may have unintended consequences such as limiting insurance products or stagnating growth.

U.S. state regulators have also been frustrated by an IAIS decision in 2015 to limit participation in its work. As a result of closed door meetings, state regulators are unable to provide a U.S. perspective. They say this lack of transparency and accountability brings into question both the credibility and the legitimacy of the work.

Trade Association and Insurer Perspectives

U.S. trade associations, primary insurers and reinsurers have taken a strong stance against foreign-imposed global capital standards. Some claim the Financial Standards Board does not appreciate the critical variances between banks and insurers and hence should not be making significant decisions affecting insurance markets. Furthermore, they say the IAIS has neither demonstrated a need for global standards nor has it clearly defined any problems or performed any cost-benefit analyses. Their standards would only place unwarranted and exorbitant costs and other burdens, without notable regulatory benefit.

There is consensus, they say, that the current U.S. system is robust and already provides important safeguards that have long served the industry and markets well. Higher capital requirements that follow banking or Solvency II rules are not necessary, especially since the industry has shown its resilience to market disruptions and catastrophes. The policyholder surplus (or net worth) of the P/C insurance industry is at a record, as shown in Figure 5.

Fig. 5
P/C POLICYHOLDER SURPLUS, 2006-2015
($ Billions)

* Through second quarter.
Source: A.M. Best.

Other concerns include:

- A complex and prescriptive ComFrame is simply not practical. Large international insurers differ in exposures, geographic scope, product lines, distribution channels, customer base

and other areas. All those differences means the type of comparability that the IAIS is seeking would not be easily achieved.

- Some observers believe undercapitalization is not the cause insurance companies to fail. If that is the case, global capital standards are not necessarily a solution and the IAIS should make sure insurers price products more accurately and maintain adequate reserves.

- Any capital standard must follow a pragmatic approach, recognize local requirements and be set as a minimum solvency measure. Development of the standard should be done incrementally, benefiting from the best practices of regulators worldwide while keeping in place local capital requirements that work well.

- The IAIS should spend more time refining group supervision tools to enhance global cooperation. Not only would supervisors be in a better position to determine whether insurers have adequate capital, but they could also more accurately evaluate insurers' risk management and governance.

- Despite all of the work, questions remain. For example, who determines capital sufficiency? If this is the role of a group supervisor, what legal authority does a supervisor in one jurisdiction have to order an insurer to add capital in another? If a group needs additional capital, to which entity should it be added?

- Global convergence may result in unintended consequences. These would likely include:

    - "Altering the competitive balance" between purely domestic insurers and internationally active insurers.
    - "Changing a U.S. insurance regulatory approach that has historically worked.
    - "Creating pressure to supplant local rules with international standards.
    - "Increasing consolidation, reducing market discipline, and ultimately driving more homogeneity in insurer behaviors, to the detriment of diversity and financial resilience."[48]

- Higher financial standards may encourage some insurers to stop writing lines that require a lot of capital in favor of ones that require little. This could reduce product availability or increase prices.

- Foreign regulations could create two classes of insurers: internationally active groups and everyone else. They would differ in how much capital they needed. The situation invites questions:

    - If one class of insurers is perceived as receiving unfair treatment relative to the other, how would this impact the market?

- Would the standards create advantages or disadvantages in specific insurance markets?

The latest proposals for higher loss absorption requirements—the extra capital that systemically important insurers must hold—present the typical concerns. The additional capital would be a percentage of the basic capital requirement, which is the stopgap measurement systemically important insurers would comply with while they await a formal international standard.

Eight of the nine systemically important insurers—AIG was the exception—question why companies are targeted, suggesting it makes more sense to restrict risky activities themselves.

The basic capital requirement uses volatile inputs, they note. The International Actuarial Association expressed concern over using market valuations, which gyrate with the financial markets. Systemically important U.S. insurers worry about the use of long-term discount rates, which also can change abruptly. Making the higher loss requirement a percentage of the basic requirement doubles down on the volatility.

Meanwhile, it is starting to appear that the eventual standard—the international capital standard—will be higher than the basic capital requirement in place now. The IAIS has proposed a sort of on-ramp to move from one standard to the other: a 33 percent increase in the basic requirement—11 percent annually for three years.

All of these measures would become more complex if the IAIS falls behind in creating the eventual capital standard.

The current proposals, though, do not seem overwhelming. The IAIS concluded the nine systemically risky insurers in 2013 and 2014 had 2.6 times as much capital as they would need.

But the process creates a lot of uncertainty for insurers. “There is a lack of clarity and certainty for executives, who need to know what the capital charges are going to be and how capital management will be affected,” said Thomas Leonardi, a former Connecticut insurance commissioner who is a senior advisor at Evercore Partners, an independent investment bank.[49]

Development of Regulatory Standards in the U.S.

As an alternative to IAIS-crafted regulations, the Fed, FIO, NAIC and insurance regulators have been developing a U.S. capital model for large, internationally active insurers.[50]

U.S. model builders are accounting for the unique needs of the U.S. insurance sector. The model will be designed to promote competition and consumer choice and safeguard policyholder protection and financial stability. No common approach has been determined. Supporters of the set of U.S. regulators believe that ample time should be allowed to develop and implement the approach under the Fed rulemaking process and study its impact before considering any IAIS model.

THE IMPACT OF HIGHER GLOBAL CAPITAL STANDARDS ON U.S. P/C MARKETS

Although higher insurance capital standards are intended to promote financial stability, the CEA, a group of European insurance associations, analyzed Solvency II[51] and concluded:

> Reliance on capital requirements alone is insufficient. Indeed, analysis of the history of insurance company insolvencies has shown that the vast majority of insolvencies were preceded by either internal management or governance shortcomings or some external trigger events.

Furthermore, "overly prudent capital requirements do not help insurers and regulators in further reducing the risk of financial distress…" and "placing excessive capital requirements on the insurance industry would have widespread detrimental effects…"

According to the CEA, there is a price to pay for overly prudent capital requirements. Their analysis parallels the critique of the U.S. regulatory community. Specifically:

- "….potentially excessive capital charges may trigger a wave of reactions that would probably include an increase in the price of more capital-intensive products, the reduction of policyholder coverage and … possibly even the reduction of underwriting capacity in the most affected lines (e.g., natural catastrophe covers)."
- "…substantially higher capital charges may reduce investor returns, which may trigger a reduction in new capital investments…, reducing in turn the underwriting capacity of the industry, and increasing funding costs."
- "Small and medium-sized players, which are more affected by higher capital charges in the absence of sufficient scale and diversification effects, might be forced to consolidate with larger groups or exit the business."
- "Policyholders, both private households and commercial buyers, would suffer the most from overly prudent capital requirements."

Impact on Internationally Active P/C Groups in the U.S.

Sonecon, LLC,[52] recently examined the impact of higher global capital standards on the premiums, investment growth and income of large, internationally active insurance groups operating in the United States. Its analysis of seven IAIGs[53] was based on the premise that an increase in capital standards that causes a drop in the insurance industry's return on equity typically requires an increase in premium in order to maintain a similar return.

Using assumptions of 15 and 30 percentage point increases in capital requirements, with all other factors being equal, Sonecon determined the impact of higher standards on large insurers' personal lines premiums and investments, shown in Figure 6.

Fig. 6
IMPACT OF RAISING CAPITAL REQUIREMENTS ON INTERNATIONALLY ACTIVE GROUPS

	15 percentage point increase	30 percentage point increase
Avg. auto/homeowners premium, 2014-2018	$34 per year (auto) $45-$55 per year (HO)	$68 per year (auto) $90-$109 per year (HO)
New premium growth, 2014-2018	$2.9 billion reduction per year	$7.3 billion reduction per year
Growth in investment, 2014-2018	Total $726 million reduction	Total $1.8 billion reduction
Investment shift from risky assets to safer investments, 2014-2018	Total of $9.4 billion	Total of $9.4 billion
Investment income, 2014-2018	Total $28.9-$54.5 million reduction	Total $28.9-$54.5 million reduction

Impact on Other Insurers
The possibility of imposing global capital standards on other insurers—even those that pose no systemic risk and do not operate internationally—cannot be overlooked. One way to consider this possibility is by looking at risk-based capital ratios (RBC) for insurers of various sizes. These RBC ratios indicate the adequacy of capital, given an insurer's size and the degree of risk assumed. The ratio itself is actual capital ("total adjusted capital") divided by the required or risk-based capital. For example a company with a 200 percent RBC ratio has capital equal to twice its risk-based capital, the latter being the minimum needed to take on all the risks the insurer takes. Put another way, an RBC ratio of 200 percent means that the company holds $200 of capital for every $100 of risk taken. As shown in the Sonecon report, RBC ratios vary considerably among insurers, based on their asset size.[54]

Based on Sonecon's 2012 median RBC ratios,[55] the I.I.I. estimates that P/C insurers with smaller assets (less than $500 million) hold about 1.8 to 2.5 times more capital per unit of risk ($897 to $1,269 compared to $502) than insurers with larger assets, as shown in Figure 7 on the next page. It should not be surprising that smaller insurers have higher RBC ratios; they may choose to operate with higher capital margins (i.e., the excess of actual capital over required capital) since

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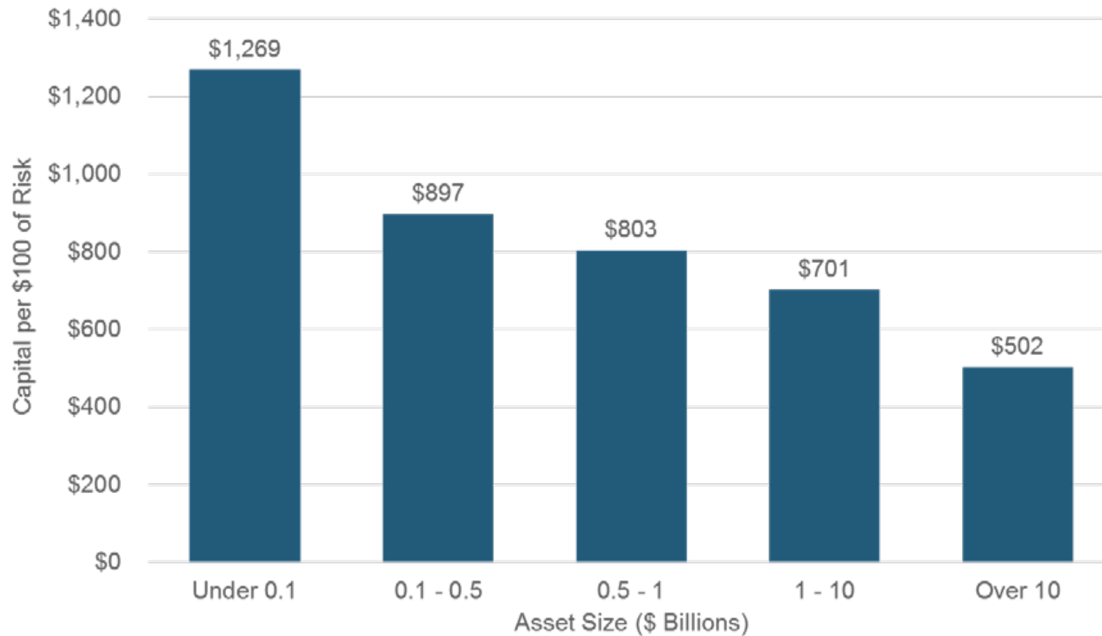
they tend to be less diversified and may have greater vulnerability to various shocks due to their size.

Fig. 7
CAPITAL HELD BY P/C INSURERS VARIES BY ASSET SIZE



Sources: Insurance Information Institute, based on data from Sonecon and SNL Financial LC.

Since smaller insurers have higher levels of capitalization, a mandate to hold even more could have far-reaching effects. It could mean an increase in mergers and acquisitions, as mentioned earlier by the European trade consortium CEA in its analysis. It could also result in higher costs because smaller firms would have to buy more reinsurance. Another possibility is a withdrawal from the market, which could reduce competition among insurers and leave consumers with fewer choices of products, perhaps at higher prices.

Not only does the impact of higher prudential capital standards differ based on the size of the insurer, but it also differs based on the structure of the insurer and the lines of business it writes. Mutual insurers could face a competitive disadvantage, attributable to their structure, in which the policyholder is also considered an owner. The policyholder-as-owner relationship implies that these insurers are unlikely to substantially increase their rates quickly to raise external capital. Yet their structure also limits their access to public financial markets; and they have higher RBC ratios than stock insurers that have easier access to these markets.

To raise cash they might consider demutualizing (i.e., converting to a stock company). Or they might consider changing their operating model and merge with other insurers to create an expanded corporation that is more financially sound. [56, 57]

One study[58] that examined long-tail versus short-tail lines of insurance concluded that the former tends to generate less income from underwriting than the latter. Hence, long-tailed insurers are at a disadvantage in terms of raising internal capital.

CONCLUSION

Since the latest financial crisis, the global solvency regulatory landscape has been in a state of flux. The IAIS is committed to developing a common methodology and a global capital standard that would provide a level playing field across regulatory regimes. If international rules are imported to the United States, the nation's regulatory system may undergo a major transformation. In the meantime, the set of U.S. regulators is working toward a U.S. approach to more effective and efficient capital regulation, while advocating for a system under which insurance regulators and supervisors can mutually recognize their work without rewriting it. In light of these activities, it is crucial that all insurers follow this issue closely, understand the potential implications and provide critical input to ensure the protection of U.S. state-based insurance regulation and markets.

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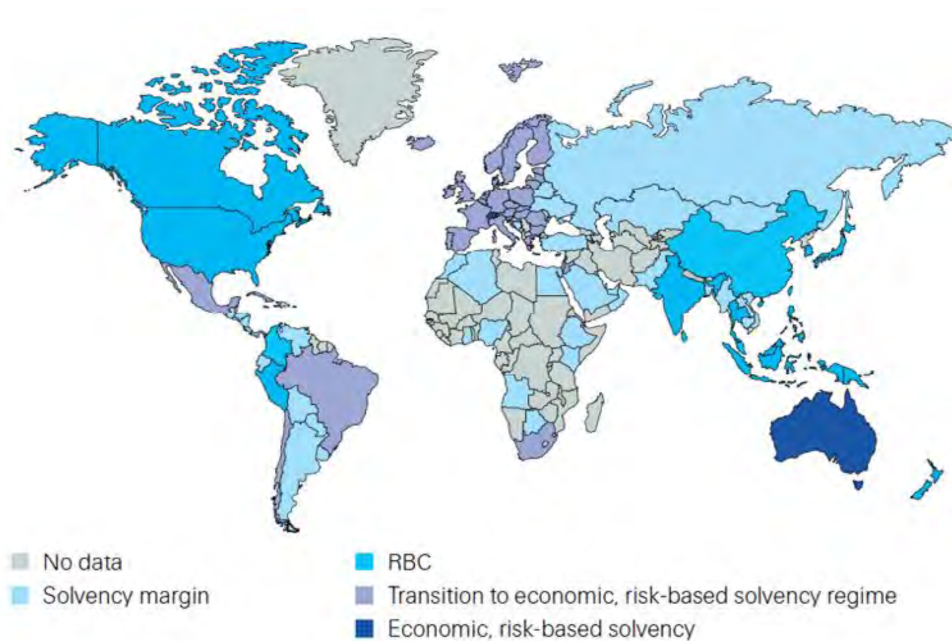
APPENDIX I

INSURANCE REGULATORY REFORM ACTIVITIES IN CHINA AND OTHER COUNTRIES

The 2007-2009 economic crisis has had a long-lasting and profound impact on financial services sectors around the world. To strengthen financial stability, enhance prudential regulation and build global alliances, insurance markets in both developing and well-established nations have been taking steps to bolster their solvency regulatory systems. Some of these efforts stem from assessments made by the IMF/World Bank regarding countries' compliance with the IAIS Insurance Core Principles.

Besides the U.S. and Europe, China has developed a comprehensive solvency regime, which is described below. Many other countries have been modifying their systems as well; a brief discussion of several nations' reform activities follows.

Fig. 8
SOLVENCY REGIMES AROUND THE WORLD



Source: Swiss Re Economic Research and Consulting.

China[59]
China's insurance industry is now the third largest (2014). Since March 2012, the China Insurance Regulatory Commission (CIRC), has been redeveloping its nation's capital regime; China's Risk Oriented Solvency System (C-ROSS) has regulatory authority over insurance holding groups, non-

insurance holding companies, and conglomerate groups.[60] Based on the principle of "giving the market a decision role in resource allocation," the objective of C-ROSS is to allow free market forces to operate in order to stimulate innovation and effectively identify, analyze and measure the risk profile of insurers more accurately and promptly.

The C-ROSS framework is made up of three pillars:

(1) Quantitative requirements for insurers to hold adequate capital; regulatory tools include available capital evaluation criteria, minimum capital requirements, capital classification, stress testing and supervisory measures.

(2) Qualitative requirements for risks in emerging or immature markets that cannot be quantified easily due to incomplete data. Some regulatory tools include solvency risk management requirements and assessment, liquidity risk supervision and supervisory inspection and analysis.

(3) A market discipline mechanism for risks other than those under Pillars 1 and 2. Regulatory tools include requirements governing insurers' public information disclosure on solvency, a sustainable means of communication between regulators and market stakeholders and insurer ratings issued by credit rating agencies.

The three-pillar structure allows C-ROSS to be comparable with other solvency mechanisms in the world. By becoming more closely connected with other international markets, China will be able to attract more foreign capital and have a larger global presence. At present, C-ROSS is in a transitional implementation stage that began in early 2015; full implementation will be determined after an evaluation by the CIRC.

Latin America[61]

Three Latin American nations (Brazil, Chile and Mexico) have made considerable progress in developing new risk-based solvency capital regimes:

- Restrictive measures that tend to discourage modernization in Brazil have prompted the Superintendence of Private Insurance (SUSEP) to implement rules and directives, including the regulation of different types of risks (e.g., credit, operational and market), in piecemeal fashion. A hybrid risk-based capital (RBC) model is now in place, and an ORSA (Own Risk and Solvency Assessment) framework is planned for operation in 2015.

- Under the aegis of the Superintendence of Securities and Insurance (SVS), Chile is revising its corporate governance and ERM regulations and refining its calculation of RBC using a value-at-risk (VaR) methodology. Insurers will be required to undergo a self-assessment of their risk management and capital sufficiency. Chile's regulatory system is akin to Solvency II and is expected to go into effect in 2016.

- Mexico's new economic regime that is overseen by the Insurance and Surety National Commission (CNSF) borrows from Solvency II, U.S. regulations and the Swiss Solvency Test. Implementation is expected in 2015. Like Chile, it uses a VaR approach to determine risk capital requirements. Given the country's high potential for natural catastrophes, the capital requirements will take into consideration earthquake and hurricane exposures. Solvency testing requires that insurers' capital positions be tested against periodically updated stress scenarios.

South Korea[62]

The South Korean insurance industry is eighth largest in total premium volume. After its EU Solvency-type regime was found to be weak in assessing the total risk of insurers, the country's two financial supervisory authorities (the Financial Services Commission and Financial Supervisory Service) put into place a risk-based capital approach similar to that of the United States, Canada and Australia in April 2011.

To further strengthen the country's financial regulations, an "RBC road map" was announced by the supervisory authorities in July 2014. This map will follow the principles underlying both the EU Solvency II and the NAIC Solvency Modernization Initiative. It is said to be a collection of policy changes related to the measurement and management of risk and the assessment of insurance liability in a more refined way to reflect the "fair" value. These changes will be implemented in various stages over five years.

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APPENDIX II

EU-U.S. MUTUAL REGULATORY UNDERSTANDING DIALOGUE PROJECT SUMMARY OF "THE WAY FORWARD" REPORT
(JULY 2014 UPDATE)

The table below summarizes the main objectives for each of the seven key areas addressed in the EU-U.S. Way Forward Update.[63] These areas are considered essential for sound regulation and effective financial stability and consumer protection. Also included are some of the steps needed to achieve these objectives.

Key Areas	Objective	Action Steps
1 - Professional secrecy and confidentiality	Promote the free flow of information between EU and U.S. supervisors under conditions of professional secrecy by removing barriers to information exchange	Have constituents join IAIS Multi-lateral Memorandum of Understanding; assess effectiveness of EU-U.S. MOUs on information exchange
2 - Group supervision	Have a robust regime of effective group supervision, holistic approach to determine group solvency/financial condition, greater cooperation and coordination among regulators, and efficient enforcement measures for effective supervision	U.S. to report on total system of supervision; EU-U.S. to share best practices among supervisors, harmonize ORSA reports, and promote effective college procedures and greater comparability of solvency among groups
3 - Solvency and capital requirements	Develop an approach to valuation which accurately reflects insurers' risk profile, is sensitive to changes in risk profile and which has capital requirements that are fully risk-based, transparent and consistent	EU-U.S. to share views on developing capital standards; establish transparent calibration with a time horizon; have a consistent approach to solvency; study standards vis-à-vis other financial tools
4 - Reinsurance and collateral requirements	Have a consistent approach within each jurisdiction; study the reduction and possible removal of collateral requirements to ensure a risk-based determination of all reinsurers relative to reinsurance credit	U.S. to study NAIC Model laws on reinsurance credit passed in different states and work with EU toward a covered agreement based on Model

– continued on following page –

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Key Areas	Objective	Action Steps
5 - Supervisory reporting, data collection and analysis	Have greater coordination in monitoring insurers' solvency and financial condition through analysis of supervisory reporting; facilitate exchange of information via exchange of best practices and greater consistency of reporting	EU-U.S. to learn from each other's experiences: EU group reporting and NAIC centralized database/analysis; both to explore greater consistency in group reporting, possible data exchange and platforms for data sharing
6 - Peer reviews	Ensure a consistent application of prudential requirements and commitment to supervisory best practices through different peer review processes, so independent view of jurisdiction is examined	EU to implement process to oversee supervisory-related tasks carried out; U.S. to consider including supervision of colleges in the accreditation program; both to coordinate best practices to promote consistency of group supervision across jurisdictions
7 - Independent third party review & supervisory on-site examinations	Ensure consistency and effectiveness in the supervision of solo entities and groups	EU to learn from U.S. experience in supervisory tools and consider need for more consistent standards re: actuarial credentials; both to promote enhanced cooperation and have ongoing dialogue re: consistent requirements for on-site monitoring and examinations

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LIST OF KEY ACRONYMS

BCR:	Basic (or Backstop) Capital Requirement
EIOPA:	European Insurance and Occupational Pensions Authority
ERM:	Enterprise Risk Management
EU:	European Union
FAST:	Financial Analysis Solvency Tools
FIO:	Federal Insurance Office
FRB:	Federal Reserve Board
FSAP:	Financial Sector Assessment Program
FSB:	Financial Stability Board
FSOC:	Financial Stability Oversight Council
G-SII:	Global Systemically Important Insurer
HLA:	Higher Loss Absorption (or Absorbency)
IAIG:	Internationally Active Insurance Group
IAIS:	International Association of Insurance Supervisors
ICP:	Insurance Core Principle
ICS:	Insurance Capital Standard
III:	Insurance Information Institute
IMF:	International Monetary Fund
IRIS:	Insurance Regulatory Information System
NAIC:	National Association of Insurance Commissioners
ORSA:	Own Risk and Solvency Assessment
RBC:	Risk-Based Capital
SIFI:	Systemically Important Financial Institution

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ENDNOTES

[1] National Association of Insurance Commissioners, "The United States Insurance Financial Solvency Framework," 2010, 6, http://www.naic.org/documents/committees_e_us_solvency_framework.pdf. The NAIC is a standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories.
[2] This paper focuses on the regulation of property/casualty (P/C) insurance rather than life or health.
[3] In general, an insurance group is comprised of two or more insurers, but there could be other legal entities involved as well, such as holding companies, subsidiaries or affiliates (e.g., agencies, service providers or third party administrators) whose business is tangential to that of the member insurers, as well as other entities whose business is unrelated to the insurance operations of the group.
[4] National Conference of Insurance Guaranty Funds, "Frequently Asked Questions about Guaranty Funds," http://ncigf.org/media-faqs. With the exception of New York (which uses a pre-insolvency system), the states' P/C guaranty funds assess after an insolvency occurs. A separate set of state guaranty associations and laws provides protection for life and health insurance claims.
[5] In 1869, the Supreme Court held in the case of *Paul v. Virginia* (75 U.S. 168) that "issuing a policy of insurance is not a transaction of commerce;" hence, states were responsible for the taxation and regulation of insurance. This ruling was subsequently overturned on June 5, 1944, by the Supreme Court that decided the insurance industry was subject to regulation by the U.S. Congress (*United States v. Southeastern Underwriters*, 322 U.S. 533). The following year, state regulation was once again declared exempt from most federal regulation and anti-trust laws by the McCarran–Ferguson Act, 15 U.S.C. §§ 1011-1015, Public Law 15, 79th Congress, approved March 9, 1945.
[6] U.S. Congress, House Comm. On Energy and Commerce, *Failed Promises: Insurance Company Insolvencies*,. February 7, 1990, 101st Cong., 2nd sess., 1990, H.R. Rep. 26-370.
[7] NAIC, "Financial Regulation Standards and Accreditation Program," April 2015, 1 and 11, http://www.naic.org/documents/committees_f_FRSA_pamphlet.pdf.
[8] All states, including the District of Columbia and Puerto Rico, are now accredited.
[9] GAO, "Insurance Regulation: The Financial Regulation Standards and Accreditation Program of the National Association of Insurance Commissioners," April 9, 1992, Summary of Statement, http://www.gao.gov/assets/110/104465.pdf. In later research, the GAO found that "the program has demonstrated its value by defining a common set of basic regulatory requirements for solvency regulation..." GAO, "Insurance Regulation: The NAIC Accreditation Program Can Be Improved," Aug. 2001, 1, http://www.gao.gov/assets/240/232633.pdf.
[10] The NAIC RBC standards focus on three major areas – asset risk, underwriting risk and other types of risk. A company can trigger four possible levels of action: (1) company action; (2) regulatory action; (3) authorized control; and (4) mandatory control. NAIC, "Risk Based Capital," *last updated 2/27/15,* http://www.naic.org/cipr_topics/topic_risk_based_capital.htm.
[11] Congressional Research Service Issue Brief for Congress, "Insurance Regulation: Background and Issues," updated May 14, 2003, CRS-3, http://assets.opencrs.com/rpts/IB10106_20030514.pdf.
[12] The NAIC's Risk Management and Own Risk and Solvency Assessment Model Act was adopted in September 2012. ORSA applies to any individual U.S. insurer that writes more than $500 million of annual direct written and assumed premium, and/or insurance groups that collectively write more than $1 billion

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[23] According to Mark E. Van Der Weide, Deputy Director of the Division of Banking Supervision and Regulation of the Board of Governors of the Federal Reserve System, the insurance holding companies overseen by the Fed represent approximately one-third of U.S. insurance industry assets.
[24] NAIC, "A Comparison of Solvency Systems: US and EU," May 22, 2008, and accompanying letters, Attachment Two-B, Financial Condition (E) Committee, Dec. 8, 2008, http://www.naic.org/documents/committees_ex_isftf_isawg_att-2b_08_draft_us_eu_comparison.pdf.
[25] State regulators also enforce rating laws and conduct rigorous market conduct examinations.
[26] Guaranty funds also operate in Puerto Rico (all lines) and the U.S. Virgin Islands (P/C lines only). In its annual report, the National Conference of Insurance Guaranty Funds (NCIGF) states: "the existing insurance guaranty system is able to enjoy the operational efficiencies of a national system, while effectively responding to the often-local concerns of insurance consumers experiencing financial and other stresses associated with the failure of their insurance company." Today, the overall assessment capacity of the P/C guaranty fund system is about $7.3 billion, renewable every year. NCIGF, "Protecting Policyholders: An Overview of the Property and Casualty Insurance Guaranty Fund System," 2014, 8 and 11, ncigf.org/media/files/2015_GF_brochure.pdf.
[27] A one-year 99.5 percent value-at-risk confidence level means that capital should not be expected to fully decline over 99.5 years out of 100.
[28] European Commission Fact Sheet, "Solvency II Overview – Frequently Asked Questions," January 12, 2015, http://europa.eu/rapid/press-release_MEMO-15-3120_en.htm
[29] Several European insurers that became insolvent or were in liquidation are Euroasig (Romania, 2008), Eurolife Assurance International Limited (Gibraltar, 2007), Independent Insurance Company Limited (Ireland, 2001), and Lemma Europe Insurance Company Limited (Gibraltar, 2013).
[30] European Commission, "WHITE PAPER on Insurance Guarantee Schemes," Brussels, COM(2010) 370, 2, http://ec.europa.eu/finance/insurance/consumer/guarantee _schemes/index_en.htm#maincontentSec1.
[31] Despite being granted a "provisional equivalence" designation, the United States did not expressly seek any type of determination by EIOPA.
[32] "EU-U.S. Dialogue Project Technical Committee Reports, Comparing Certain Aspects of the Insurance Supervisory and Regulatory Regimes in the European Union and the United States," issued Dec. 2012, https://eiopa.europa.eu/Publications/Reports/EU_US_Dilaogue_Project_Factual_Report.pdf#search=filename%3AEU%5FUS%5FDilaogue%5FProject%5FFactual%5FReport%2Epdf.
[33] "EU-U.S. Dialogue Project: The Way Forward: Objectives and Initiatives for the Future," Dec. 2012, 3, https://eiopa.europa.eu/Publications/Protocols/EU_US_Dialogue_Project_The_Way_Forward_December_2012.pdf, and EU-U.S. Insurance Project, "The Way Forward, July 2014 Update," https://eiopa.europa.eu/Publications/Events/Updated_Way_Forward_document.pdf.
[34] IAIS, "Insurance Core Principles, Standards, Guidance and Assessment Methodology, 1 Oct. 2011, ICP 9 amended 12 Oct. 2012, ICP 22 amended 19 Oct. 2013," http://www.tsb.org.tr/images/Documents/Insurance_Core_Principles__Standards__Guidance_and_Assessment_Methodolog%20EN.pdf, and NAIC "Insurance Core Principles," *last updated* 2/27/15, http://www.naic.org/cipr_topics/topic_insurance_core_principles.htm.
[35] NAIC, *Center for Insurance Policy & Research Newsletter*, "Navigating the Regulatory Alphabet Soup," http://www.naic.org/cipr_newsletter_archive/vol12_regulatory_alphabet_soup.pdf.
[36] International Monetary Fund, IMF Country Report No. 15/90, "United States, Financial Sector Assessment Program, Detailed Assessment of Observation on Insurance Core Principles," April 2015, 5-6,

https://www.imf.org/external/pubs/ft/scr/2015/cr1590.pdf. The FSAP is conducted every five years to analyze the strength and scope of an insurance regulatory system under the standards of the ICPs.
[37] Yoshihiro Kawai, "Development of International Insurance Supervisory Standards," Presentation, November 19, 2013, http://www.assalweb.org/assal_nueva/documentos/upload/01_Kawai.ppt.
[38] The IAIS states it will not drive the process of identifying IAIGs although it may ultimately compile a list. Supervisory colleges will be the ones that identify IAIGs. IAIS, "Frequently Asked Questions for The IAIS Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame)," Updated June 25, 2015, 4, http://www.iaisweb.org/index.cfm?event=openFile&nodeId=52819.
[39] NAIC, "Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame)," last updated 2/12/2015, http://www.naic.org/cipr_topics/topic_comframe.htm.
[40] In 2014, nine insurers worldwide were designated as G-SIIs. Three (AIG, MetLife and Prudential Financial) are domiciled in the U.S.; the remaining six are Allianz SE, AXA SA, Aviva PLC, Assicurazioni Generali SpA, Ping An Insurance (Group) Co. of China, Ltd., and Prudential PLC (Allianz and AXA also operate in the U.S.). The list of G-SIIs is updated by the FSB each November.
[41] IAIS, "Capital Requirements for Global Systemically Important Insurers (G-SIIs): Basic Capital Requirements (BCR) and Higher Loss Absorbancy (HLA)," October 5, 2015, http://iaisweb.org/index.cfm?event=openFile&nodeId=57111.
[42] IAIS, "Higher Loss Absorbency Capacity for Global Systemically Important Insurers (G-SIIs), June 25, 2015, http://www.fsa.go.jp/inter/iai/20150626-1/02.pdf.
[43] The White House, "FACT SHEET: The 2015 G-20 Summit in Antalya, Turkey," November 16, 2015, https://www.whitehouse.gov/the-press-office/2015/11/16/fact-sheet-2015-g-20-summit-antalya-turkey.
[44] IAIS, "Frequently Asked Questions for The IAIS Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame)," Updated June 25, 2015, 6, http://www.iaisweb.org/index.cfm?event=openFile&nodeId=52819.
[45] Testimony of Federal Reserve System Board of Governors Deputy Director of the Division of Banking Supervision and Regulation, Mark E. Van Der Weide, before the Senate Committee on Banking, Housing, and Urban Affairs, April 28, 2015, http://www.federalreserve.gov/newsevents/testimony/vanderweide20150428a.htm.
[46] Testimony of FIO Director Michael McRaith before the House Financial Services Subcommittee on Housing and Insurance, Nov. 18, 2014, http://www.treasury.gov/press-center/press-releases/Pages/jl9703.aspx.
[47] Testimony of Kevin McCarty, Commissioner, Florida Office of Insurance Regulation, on behalf of the NAIC before the Subcommittee on Housing and Insurance, U.S. House Committee on Financial Services, April 29, 2015, http://www.naic.org/documents/government_relations_150429_mccarty_house_testimony.pdf, and NAIC documents on U.S. regulators' views on ComFrame (April 2015) and international capital proposals (April 2015), and comments on IAIS ICS Public Consultation Document (February 13, 2015), respectively, http://www.naic.org/documents/committees_g_comframe_position_statements.pdf?123, http://www.naic.org/documents/committees_g_capital_position_statements.pdf, and http://www.naic.org/documents/committees_g_related_naic_comments_iais_ics_draft.pdf.
[48] Therese M. Vaughan, Drake University, and Calabria, Mark A., Cato Institute, "International Developments in the Insurance Sector: The Road to Instability?" April 27, 2015, 3, http://www.pciaa.net/docs/default-source/default-document-library/final-vaughan-calabria-international-insurance-developments-white-paper-amp-exec-summary----april-27.pdf?sfvrsn=2.

[49] Philip Alexander, “Regulators forge ahead with higher loss absorbancy,” Global Risk Regulator, November 2015.
[50] A U.S. standard under the aegis of the Federal Reserve Board is consistent with the Insurance Capital Standards Clarification Act of 2014 and the underlying objectives of the Dodd-Frank Act.
[51] CEA, “Why excessive capital requirements harm consumers, insurers and the economy,” March 2010, http://www.insuranceeurope.eu/uploads/Modules/Publications/1268293182_cea-capital-requirements-report.pdf. CEA (Comité Européen des Assurances) is the European insurance and reinsurance federation of more than 30 national insurance associations, representing about 94 percent of total European premium income.
[52] Sonecon, LLC was founded as an economic advisory firm in 2001 by Robert Shapiro, a former senior government official and economic advisor with deep experience in Washington and around the world. Its report, “Unnecessary Injury: The Economic Costs of Imposing New Global Capital Requirements on Large U.S. Property and Casualty Insurers,” November 2014, was supported by two P/C trade associations: National Association of Mutual Insurance Companies and Property Casualty Insurers Association of America. http://www.sonecon.com/docs/studies/Report_on_Capital_Standards_for_PC_Insurers-Shapiro-Mathur-Sonecon-Final-November-15-2014.pdf.
[53] The seven U.S. IAIGs analyzed by Sonecon are Liberty Mutual Group, American International Group, Travelers’ Companies, Berkshire Hathaway, Chubb Group, ACE Group and CNA Insurance Services, representing 26.6 percent of the current U.S. P/C market.
[54] Society of Actuaries Risk Management Task Force, “Risk Based Capital,” 1, http://rmtf.soa.org/riskbased_capital.pdf, and CRE Finance Council Annual Conference Powerpoint, “Risk Based Capital,” June 11-13, 2012, http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Events/Major_Conferences/CMSA-Annual_Convention/2012/Wheres_the_MEAF.pdf.
[55] Sonecon’s RBC ratios are grouped further by the III, weighted by P/C company assets.
[56] Leo de Haan and Kakes, Jan, “Solvency of Stock Versus Mutual Insurers: Evidence from Dutch Panel Data,” Feb. 2007, http://www.actuaries.org/AFIR/Colloquia/Stockholm/deHaan.pdf. Note: even though the study examined Dutch insurers, it is believed that the findings apply to U.S. insurers as well.
[57] NAIC, “Capital Markets Special Report,” April 28, 2015, http://www.naic.org/capital_markets_archive/150428.htm.
[58] Leo de Haan and Kakes, Jan, “Solvency of Stock Versus Mutual Insurers: Evidence from Dutch Panel Data,” Feb. 2007, 7, http://www.actuaries.org/AFIR/Colloquia/Stockholm/deHaan.pdf.
[59] The Geneva Association Newsletter, Regulation and Supervision, Jungbo Xiang, Chairman, China Insurance Regulatory Commission, “C-ROSS, A Major Reform of China’s Insurance Regulatory System,” No. 59, June 2015, https://www.genevaassociation.org/media/920437/ga2015-progres59-xiang.pdf.
[60] Conglomerate groups are groups of multiple insurance companies (jointly) controlled by a single, de facto controller or people acting in concert with no explicit controller.
[61] Swiss Re, “Insurance solvency regulation in Latin America: modernizing at varying speeds,” January 2015, http://media.swissre.com/documents/Insurance_solvency_regulation_in_Latin_America.pdf.
[62] The Geneva Association Newsletter, Regulation and Supervision, Soonjeung Lee and Kim, Hae Sik, Korea Insurance Research Institute, “Recent Regulatory Changes in the Korean Insurance Industry,” No. 59, June 2015, https://www.genevaassociation.org/media/920431/ga2015-progres59-leekim.pdf.
[63] EU-U.S. Insurance Project, “The Way Forward, July 2014 Update,” https://eiopa.europa.eu/Publications/Events/Updated_Way_Forward_document.pdf.

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Catastrophe Bonds

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Catastrophe Bond Overview

A Catastrophe Bond (aka cat bond) is an Insurance-Linked Security (ILS) developed by the Property & Casualty (P&C) insurance industry during the 1990s in the aftermath of Hurricane Andrew in Florida and the Northridge earthquake in California. These financial instruments were seen as a way to protect the P&C insurance and reinsurance markets from catastrophic losses by transferring risk exposures to investors in the capital markets. The primary ILS instrument developed for this purpose was the catastrophe bond. The catastrophe bond market is concentrated around property risks with underlying exposures to U.S. perils, including hurricanes, earthquakes and windstorms.

Catastrophe bonds are similar to traditional bonds where an issuer borrows a principal amount from investors and repays the principal plus a specified amount of interest at maturity. Catastrophe bonds can be issued as public offerings or private placements, and can trade in secondary markets. The distinguishing feature of catastrophe bonds is the investor requirement to forgive some or all payments of interest or principal if a specified triggering event occurs. The triggering event can be defined in various ways, but typically reflects a situation where the issuing insurer experiences catastrophic losses. If no triggering event occurs, the bond principal and accrued interest is returned to the investor at maturity.

Catastrophe bonds are transferred to capital market investors through a Special Purpose Vehicle (SPV). The use of an SPV protects both the issuing insurer and investors. The SPV deposits proceeds received from a bond issuance into a trust account to secure the insurer's repayment obligation. The proceeds are typically invested in high-quality assets such as money market or U.S. Treasury securities. The SPV benefit to the insurer is that bond proceeds are readily available upon occurrence of a triggering event. The SPV benefit to the bond investor is low counter-party credit risk as the insurer's solvency does not impact recoupment of the bond principal and accrued interest.

Catastrophe Bond Risks

As with other fixed-income securities, catastrophe bonds are often rated by rating agencies, such as Standard & Poor's and A.M. Best. A higher rating allows a bond to be issued at prices competitive with the cost of traditional reinsurance. Because of the potential for large losses, catastrophe bonds are typically rated at below investment grade (BB or B ratings), similar to high-yield ("junk") bonds. There have been catastrophe bonds issued with investment-grade ratings when the triggering event was considered remote. However, as demand for catastrophe bonds continues to grow, issuers are increasingly able to avoid the cost of a credit rating.

Catastrophe modeling allows an issuer to structure a bond to transfer risks that

Catastrophe Bonds

(continued)

are remote enough (lower probability of occurrence) to facilitate higher ratings. Ratings are primarily based on a bond's probability of default as determined by its 'triggering event'. The triggering event defines the type and magnitude of loss sufficient to require the bondholders' loss of principal and interest.

There are four primary types of catastrophe bond triggers:

Parametric - This trigger is a parameter of a catastrophic event, such as wind speed in a hurricane or earthquake magnitude and location. The issuer's recovery depends solely on the intensity and location of the physical event. This type of trigger has an advantage to investors because the trigger is simple to determine, allowing for rapid and transparent resolution of losses. This trigger creates a 'basis risk' to the issuer as bond recoveries may be less than actual losses incurred.

Industry Losses - This trigger is based on estimates of total insurance industry losses from a catastrophic event. The industry loss estimates are determined by a third-party service unaffiliated with the bond issuers or investors. The issuer recovers a percentage of total industry losses in excess of a predetermined attachment point. This type of trigger has an advantage to investors as losses are determined by an independent third-party and claims can be settled quickly once industry loss estimatesare complete. This trigger creates a basis risk to the issuer as bond recoveries may be less than its share of industry losses.

Modeled Losses - This trigger is based on modeling of the issuer's catastrophe exposures. When a catastrophic event occurs, expected losses are calculated by an independent third-party running the model with parameters from the event (such as wind speed in a hurricane or earthquake magnitude). The bond is triggered if modeled losses exceed a predetermined attachment point. This type of trigger has an advantage to investors as losses are determined by an independent third-party and claims can be settled quickly once modeled loss estimates are complete. This trigger creates a basis risk to the issuer as modeled loss estimates may be less than actual losses incurred.

Indemnity - This trigger is based on the issuer's actual claims incurred from a catastrophic event and is similar to traditional excess-of-loss reinsurance contracts. The bond is triggered when the insurer's losses exceed a predetermined attachment point. For example, a bond could cover losses of $100 million in excess of $200 million, meaning that the bond will be triggered if the insurer's losses exceed $200 million, and will fully default if the insurer's losses exceed $300 million. This is the most common type of trigger used by issuers as it has the advantage of no basis risk. However, this lack of basis risk results in a 'moral hazard' to investors as the issuer may have

less incentive to avoid underwriting excess catastrophe risks. This trigger is also less advantageous to investors as it does not facilitate rapid resolution of losses as repayment must wait for insurer claims to be settled.

Catastrophe Bond Rewards

Catastrophe bonds have historically offered higher yields than similarly rated fixed-income securities. This is due to factors that include modeling risk (actual investor losses exceed modeled losses) and limited demand from a small pool of potential investors, such as hedge funds and reinsurers. However, as traditional investment yields have persisted at historical lows, investor demand has shifted to alternative asset classes. This has led to lower yield spreads on ILS and catastrophe bonds when compared to traditional corporate bonds. Catastrophe bond investors today are more likely to include institutional investors (such as pension funds), dedicated ILS funds and mutual funds. Rating agencies and catastrophe modeling firms have also had roles in increasing the confidence of investors by providing analysis of catastrophe bond transactions.

Another factor in catastrophe bond pricing is available capacity in the traditional reinsurance market. Reinsurers have been experiencing 'soft market' pricing for several years. A soft market is characterized by an oversupply of reinsurance capacity, leading to a downward pressure on pricing. As the pricing of reinsurance softens, the yields offered to catastrophe bond investors also soften to match pricing in the reinsurance market.

Growth in the ILS market itself has been a factor in the soft pricing of traditional reinsurance. The total value of ILS and catastrophe bond issuances outstanding as of year-end 2015 was approximately $26 billion. This represents a new all-time market high, as has been the trend each year since 2010 when approximately $14 billion were outstanding (source: Artemis.bm Deal Directory). ILS and catastrophe bond issuances during 2014 and 2015 were approximately $9 billion and $8 billion, respectively (source: Artemis.bm Deal Directory).

Examination Considerations - Statutory Accounting

The NAIC's regulatory requirements allowing credit for reinsurance transactions are designed to ensure meaningful transfer of risk and collectibility of reinsurance receivables. Statutory reinsurance accounting for P&C companies is discussed in detail within SSAP No. 62R (Property and Casualty Reinsurance) and is addressed specifically for ILS within SSAP No. 74 (Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer through a Protected Cell). SSAP No. 74 provides statutory accounting guidance solely for indemnity-triggered ILS conducted through a protected cell (such as an SPV). Statutory accounting treatment is not allowed for non-indemnity based ILS triggers. Risk transfer through an indemnity-triggered ILS

is achieved when the SPV absorbs losses suffered by the issuing insurer without any basis risk. The collectability of reinsurance is achieved when the trust account is established to cover potential default under the bond, along with the insurer's ability to withdraw trust account funds to pay covered losses.

The statutory accounting treatment for premiums ceded through ILS and premiums ceded through traditional indemnity-based reinsurance contracts is similar. SSAP No. 74 allows the insurer to reduce their written and earned premiums by amounts paid to the SPV for underwriting insurance risks. Premiums ceded under ILS or traditional reinsurance contracts are reported individually as Reinsurance Premiums Ceded in Schedule F - Part 3 (Ceded Reinsurance).

The statutory accounting treatment for reinsurance recoverables is less favorable for ILS than for traditional indemnity-based reinsurance contracts. This is because ILS transfer of risk, and the related reduction in claim liabilities, is allowed only when losses attach through a triggering event. Under traditional reinsurance contracts, the insurer reflects transfer of risk, and the related reduction in claim liabilities, when the contract is effective. As such, Schedule F - Part 3 (Ceded Reinsurance) reporting for ILS should not indicate reinsurance recoverable amounts unless a triggering event has occurred.

The NAIC's Statutory Accounting Principles (E) Working Group adopted the following non-substantive changes that impact reporting and disclosure of ILS effective with December 31, 2015 financial statements:

- SSAP No. 1 now requires specific ILS-related narrative disclosures in the financial statements. These disclosures require information that includes the number of outstanding ILS contracts and potential ILS proceeds as of the financial statement date.

- SSAP No. 74 now requires reporting of ILS-related transactions through the designated 'protected cell' lines in the balance sheet and income statement, instead of through the 'aggregate write-in' accounts.

Examination Considerations - Other Topics

Specific guidance within the NAIC's Financial Condition Examiners Handbook necessitates an understanding and review of an insurer's use of ILS and catastrophe bonds.

Exhibit DD - Critical Risk Categories' is a tool created by the NAIC to facilitate assessment of critical solvency risks. This exhibit includes critical risk categories that may involve direct or indirect consideration of ILS and catastrophe bonds:

Catastrophe Bonds

(continued)

- **Appropriateness/Adequacy of Reinsurance Program** - An insurer's issuance of indemnity and non-indemnity triggered ILS may be part of an overall reinsurance strategy.
- **Reinsurance Reporting and Collectibility** - An insurer's financial statement presentation of ILS issuances may require consideration of statutory accounting guidance.
- **Underwriting and Pricing Strategy/Quality** - An insurer's issuance of ILS may be part of an overall strategy to manage underwriting capacity.
- **Capital Management** - An insurer's issuance of ILS may be part of an overall strategy to manage capital and financial solvency.

The NAIC's guidance regarding Own Risk and Solvency Assessment (ORSA) reporting (if applicable to an insurer) is also likely to necessitate an understanding of an insurer's use of ILS and catastrophe bonds. ILS may be an integral component of an insurer's capital modeling and stress testing of its prospective solvency.

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Darin Benck, CFE, CPA, CIA, RHU, CRMA , Director, Financial Examinations at RRC, performs financial examinations on behalf of state insurance departments. He leads the examination team providing examination administration, planning, staff supervision, review, on-the-job training and report writing on all types of insurance companies. Darin's role also involves keeping pace with changing regulatory environments to provide targeted, up-to-date advice to his regulatory clients.

Prior to joining RRC, Darin was a Senior Accountant at Walpert & Wolpoff, LLP where he performed audits, reviews and compilations for real estate companies

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NAIC Meeting Notes

Global Insurance Industry Group, Americas

NAIC 2015 Fall National Meeting

The National Association of Insurance Commissioners held its Fall National Meeting in National Harbor November 19-22. This newsletter contains information on activities that occurred in some of the committees, task forces and working groups that met there, as well as summarizes conference calls after the Fall National Meeting through December 29. For questions or comments concerning any of the items reported, please feel free to contact us at the address given on the last page.

Executive Summary

- The Executive Committee and Plenary elected its 2016 officers and gave final approval to revisions to several NAIC models and adopted other tools.
- After months of work, the Cybersecurity Task Force adopted the Cybersecurity Bill of Rights for insurance consumers, which aims to serve as a guide to understanding what personal information is being collected, and the procedures to undertake when there is a possibility of identity theft.
- The Financial Condition Committee adopted 2016 charges relating to hedge accounting and single state solutions addressing multi-state problems, based on feedback received from a survey on statutory accounting and the solvency framework.
- The Statutory Accounting Principles Working Group adopted revisions and disclosures relating to investments in subsidiary, affiliated and controlled entities and a new disclosure for insurers ceding to variable annuity captives. The working group also exposed a revised proposal for insurers to report detailed investment information on a quarterly basis.
- The Emerging Accounting Issues Working Group adopted revised guidance on risk corridor receivable assets.
- The PBR Implementation Task Force reported significant state progress on PBR adoption, which makes implementation of PBR as of January 1, 2017 much more likely. The task force also developed a 2015 financial statement disclosure for AG 48 transactions when an RBC shortfall exists.
- The Life RBC Working Group heard a presentation on longevity risk with a possible goal of including consideration of this risk in either RBC or reserving requirements. The C-3 Phase II/AG 43 Subgroup reported it will be working with the VA Issues Working Group to revise C3P2 to provide RBC relief to variable annuity writers.
- The Investment RBC Working Group continues to review comments related to its proposal to expand the corporate bond designations from six rating classes to fourteen or nineteen, and discussed comments on its revised real estate investments RBC proposal. The working group also heard input on whether and how the P/C and Health RBC formulas should be impacted by any invested asset risk changes.
- The Operational Risk Subgroup heard results of the growth risk test which compares the RBC impact of the existing embedded risk charge to the proposed charge.
- The Catastrophe Risk Subgroup adopted proposals relating to the catastrophe risk charge exemption and presentation of catastrophe charges. The calculation will now be informational only for an additional year, through year-end 2016.
- The Health RBC Working Group adopted the 2016 Underwriting Risk Instructions and exposed two proposals related to Medicaid pass-through payments.
- The Valuation of Securities Task Force adopted the macroeconomic assumptions, scenarios, and risk ratings for the 2015 financial modeling for RMBS and CMBS. The task force also concluded that the NAIC's *Derivatives Instruments Model Regulation* does not need to be revised.
- The ComFrame Development and Analysis Working Group approved its concept paper for the development of an NAIC group capital tool, which was also adopted by the International Insurance Relations Committee.
- The Reinsurance Task Force hopes to complete its work on the *XXX/AXXX Credit for Reinsurance Model Law* and adopt the revised model on January 6. During the fall, the task force had lengthy discussions regarding to what extent commissioner discretion should be allowed to scope products in or out of the model law.
- The newly formed Variable Annuity Issues Working Group adopted its Variable Annuities-Framework for Change document and exposed for comment detailed disclosures for variable and fixed annuities for 2016 financial statements.
- The Blanks Working Group adopted voluntary guidance for 2015 annual statements for reporting the description, issuer, issue and capital structure columns on Schedule D, Part 1.

- The Governance Review Task Force adopted its proposed changes to the NAIC bylaws requiring monthly Executive Committee meetings, expanded member participation in parent committees, and streamlined voting at Executive Committee.
- The Life Insurance and Annuities Committee discussed the controversial revised definition of "fiduciary" proposed by U.S. Department of Labor.
- Following the adoption of AG 49, *Application of the Life Illustrations Model Regulation to Policies with Index-Based Interest* earlier this year, a subgroup of the Life Actuarial Task Force developed and exposed proposed revisions to AG 49 to address policies with dual accounts. The task force also continued work on the PBR Valuation Manual and related matters including adoption of amendments related to PBR mortality margins, the Underwriting Criteria Scoring Calculator and the 2017 CSO valuation table.
- The PBR Review Working Group hopes to finalize the proposed annual statement VM-20 Supplement in time to be used by the participants in the 2016 PBR Pilot Project.
- The Health Actuarial Task Force Long-Term Care Valuation Subgroup worked during the interim period to gain additional insights into results from the joint SOA/LIMRA LTC policy termination experience study.
- The Financial Regulation Standards and Accreditation Committee exposed revisions to determine which risk retention groups should be considered "multi-state insurers."
- The Risk-Focused Surveillance Working Group finalized guidance on the Group Profile Summary template, which was subsequently adopted by the Financial Analysis Handbook Working Group.
- The Climate Change and Global Warming Working Group discussed the recent U.N. Climate Change Conference held in Paris.
- The Mortgage Guaranty Insurance Working Group continued work on the proposed revised Mortgage Guaranty Insurance Model Act and asked for feedback on proposed significant revisions to the reinsurance and capital standards sections.
- The Terrorism Insurance Working Group discussed NAIC and FIO data collection efforts related to the *Terrorism Risk Insurance Program Reauthorization Act of 2015*.

Executive Committee and Plenary

Note: All documents referenced in this Newsletter can be found on the NAIC's website at naic.org.

2016 Election of Officers
During the Fall National Meeting, the Executive Committee and Plenary elected the following officers:

- Director John Huff (MO), President
- Commissioner Sharon Clark (KY), President-Elect;
- Commissioner Ted Nickel (WI), Vice-President;
- Commissioner Julie Mix McPeak (TN), Secretary-Treasurer.

Each of the elected officers were unopposed in his or her nomination.

Adoption of Revised Models and Other Guidance
The Executive Committee and Plenary adopted as final the following items at the Fall National Meeting and a subsequent conference call December 17, which were the subject of public hearings and debate as they were considered by various groups of the NAIC:

- Cybersecurity Bill of Rights
- Amendments to the *Synthetic Guaranteed Investment Contracts Model Regulation* (#695)
- Amendments to *Actuarial Guideline XXXIII—Determining CARVM Reserves for Annuity Contracts with Elective Benefits* (AG 33)
- 2016 Generally Recognized Expense Table
- Recent Valuation Manual amendments
- Revisions to the *Managed Care Plan Network Adequacy Model Act* (#74)
- *Guidance for the Financial Solvency and Market Conduct Regulation of Insurers Who Offer Contingent Deferred Annuities*
- Amendments to NAIC Bylaws
- Revisions to the Part A: Laws and Regulations Accreditation Preamble

- *Risk Management and Own Risk Solvency Assessment Model Act* (#505) as an additional Part A Standard for Accreditation
- Title Insurance Consumer Shopping Tool Template and "Options for Regulators to Distribute a Title Insurance Consumer Shopping Tool"

The regulators also adopted a one-year exposure period for potential inclusion as Part A Accreditation Standards for the *Corporate Governance Annual Disclosure Model Act* (#305), *Corporate Governance Annual Disclosure Model Regulation* (#306), 2014 revisions to the *Annual Financial Reporting Model Regulation* (#205); and 2014 revisions to the *Insurance Holding Company System Regulatory Act* (#440).

Cybersecurity Task Force

Cybersecurity Bill of Rights Exposure
Subsequent to the discussions held during the Summer National meeting on a Cybersecurity Bill of Rights and a public comment period ending August 31, the task force met via conference call on October 14 to discuss an amended version. The aim of the Bill of Rights is to guide consumers, as well as insurers, in understanding what personally identifiable information is being collected, and the procedures to undertake when there is a possibility of identity theft.

During the conference call, regulators finalized edits to the Bill of Rights; however some voiced concerns as to whether their state would be able to mandate some of the provisions outlined. Further concerns were raised by interested parties from industry groups as to whether the Bill of Rights might mislead a consumer as it is not a regulation or law, but rather a goal of cybersecurity regulation. In addition, specific concerns were raised regarding the right to obtain one year identity theft protection paid by the company or agent. Ultimately, the task force adopted the Bill of Rights; however Virginia abstained and Illinois, Maryland and Nebraska dissented. The Cybersecurity Bill of Rights was also adopted by Executive Committee and Plenary during their December 17 conference call.

Update Regarding Cybersecurity Legislation
Tony Cotto, NAIC's Financial Policy and Legislation Counsel, provided an update on federal cybersecurity legislation. In October, the Senate passed the Cyber Information Sharing Act, whose main provisions aid companies' sharing of cyber threats with the government and affords them certain protections. The act was incorporated by amendment into the consolidated spending bill adopted by the U.S. House, and was signed into law by the President on December 18.

Update from IT Examination Working Group
Having discussed proposed revisions to the Financial Condition Examiners Handbook in previous meetings, as well as receiving numerous comment letters during its exposure period, the working group adopted the guidance this fall. The revisions provide examiners with guidance to address cybersecurity risks, and will be included in the 2016 handbook.

Information Sharing Presentation
The task force heard a presentation from Brian Peretti, U.S. Department of the Treasury, and Rick Lacafta, Financial Services Information Sharing and Analysis Center (FS-ISAC). Mr. Peretti noted that the Treasury Department is working with the Federal Insurance Office and the NAIC to ensure that views are aligned on issues facing the insurance sector, and ultimately its goal is to get cyber threats to relevant parties as quickly as possible.

Mr. Lacafta also gave an overview of the nonprofit, FS-ISAC and its mission to ensure the resilience of financial services infrastructure. FS-ISAC has shared data security and cybersecurity threats with its members, including cybercrime, attacks and hacktivists. FS-ISAC receives information from government and private sector sources, and privately distributes the amongst its FS-ISAC members.

Financial Condition Committee

Departure of Key Regulators
The Fall National Meeting marks the final NAIC conference for two key regulators: Joseph Torti, superintendent of the Rhode Island Insurance Department and chair of the Financial Condition Committee, and Steve Johnson, deputy commissioner of the Pennsylvania Insurance Department and founding and active member of the SAP Working Group. Mr. Torti has accepted a position with an insurer, and Mr. Johnson is retiring. Together they represent almost 60 years of insurance regulatory experience and have contributed greatly to the NAIC and their respective insurance departments.

The committee met September 17 and November 5 via conference call and in National Harbor and discussed the following projects.

Survey on Statutory Accounting and the Solvency Framework
In June, the committee exposed for comment a survey seeking feedback regarding the conservatism of NAIC statutory accounting, reserving and RBC,

whether improvements to NAIC committee processes could be made, and whether there are any emerging single state solutions addressing multi-state problems (i.e. in addition to XXX/AXXX captives). Twenty-six comment letters were received from industry and regulators, which were initially discussed during the Summer National Meeting, where there were four common themes expressed in the comment letters (discussed in more detail in the PwC's NAIC Summer National Meeting Newsletter).

During its September 17 conference call, the committee walked through each of the themes in more detail. There was significant support for changes to hedge accounting, which the committee noted the Variable Annuities Issues Working Group and SAP Working Group will be addressing in 2016. Another significant concern related to "single state solutions to multi-state problems." To address this issue, during its November 5 conference call, the committee adopted the following new charge: "oversee and implement a process to address financial issues that may compromise the consistency and uniformity of the U.S. solvency framework." As part of this charge, the committee developed and adopted a Financial Solvency Framework Maintenance Form which any party may submit directly to the committee "to prevent the use of single state solutions for national issues."

The committee also adopted the following 2016 charge for the SAP Working Group:

> Obtain, analyze and review information on permitted practices, prescribed practices, or other accounting treatments suggesting that issues or trends occurring within the industry may compromise the consistency and uniformity of the statutory accounting, including but not limited to activities conducted by insurers for which there is currently no statutory accounting guidance or where states have prescribed statutory accounting that differs from the guidance issues by the NAIC. Utilize this information to consider possible changes to statutory accounting.

Regulation of Third Party Administrators
During the Summer National Meeting, the committee discussed the Financial Analysis Working Group's ongoing oversight into the causes of troubled insurers, and specifically whether further oversite of TPAs should occur to address whether vendors are financially and operationally sound. During the November 5 conference call, the discussion continued as to whether there should be a mandatory requirement for audits of TPAs and MGAs, and whether such a requirement should be an accreditation standard. Industry representatives thought the proposed wording should allow for remote access audits and service audit reports, as the number of TPAs associated with certain lines of business would cause undue burden and expense on the insurers. During the call, the committee agreed to allow interested parties to propose new wording to allow for this, but it was not discussed further in National Harbor.

Fall National Meeting
In addition to the committee receiving reports of its various task forces and working groups, the committee heard a presentation on Issues Arising from Large Deductible Programs in Insurance Insolvencies, presented by the Property Casualty Insurance Guaranty Funds and the NCIGF. The presentation highlighted the increased exposure of these contracts to policyholder credit risk, as well as the impact to the industry of insolvencies to policyholders and insurers who write this business. The proposed solutions include statutes governing rights and obligations in insurer liquidation, legislation to govern collateral requirements and potential revisions to SSAP 65.

Statutory Accounting Principles Working Group

The working group met via conference call September 24, October 19, December 10 and at the Fall National Meeting and discussed the following projects. (After each topic is a reference to the Statutory Accounting Principles Working Group's agenda item number.)

Adoption of Revisions to SSAPs

SSAP 97, Nonadmitted Assets and Application of the SAP Guidance to SCAs (2015-08) – During the fall through its December 10 conference call, the working group worked to finalize revisions to SSAP 97 by year-end, including new disclosures.

- Nonadmitted Assets in Non-Insurance SCAs – After input from interested parties, paragraph 8 of SSAP 97 was amended to require that the carrying value of SCA entities be "adjusted as appropriate in accordance with the guidance in SSAP 25, paragraph 16d." This guidance in SSAP 25 requires insurance companies to consider whether a transaction was done to avoid statutory accounting. This results in no substantive change to statutory accounting, but is just a reminder to consider the SSAP 25 guidance.

- Valuation of U.S. Insurance SCAs – At the Fall National Meeting the working group adopted a

disclosure for 2015 annual and audited financial statements by parent insurers related to state prescribed or permitted practices of insurance SCAs investees that deviate from NAIC SAP. Those parent entities will disclose the following: 1) a description of the state prescribed or permitted practice followed by the insurance SCA entity, 2) the effect on net income and surplus of the practice on the insurance SCA entity, 3) whether an RBC level event would have been triggered without the practice, and 4) the carrying value of the investment in the insurance SCA by the parent with and without the prescribed or permitted practice.

During its December 10 conference call, the working group adopted new guidance to allow optionality in valuation of insurance SCAs: an insurer parent may value the insurance SCA either 1) in accordance with its underlying statutory equity which includes the state prescribed or permitted practice or 2) modified to remove the impact of any permitted or prescribed accounting practices that departs from the NAIC Accounting Practices and Procedures Manual. This revision was also adopted by the Financial Condition Committee during its December 11 conference call.

- Valuation of Non-Insurance SCAs Engaging in Insurance Activities and Foreign Insurance Entities – During the summer, the working group had concluded that it would not reconsider full conversion to NAIC SAP for SSAP 97 par. 8.b.ii and 8.b.iv entities. The working group then exposed for comment some additions to the current six adjustments to audited U.S. GAAP carrying value, which include the following: nonadmit assets that do not meet the requirements of SSAP 21 and SSAP 105, expense any pre-operating and research and development costs that had been capitalized for GAAP, amortize goodwill in accordance with SSAP 68 and nonadmit any surplus notes held by the SCA that have been issued by the parent insurer. The revisions were adopted by the working group in National Harbor and are effective for 2015 financial statements.

SSAP 97 SCA Disclosures (2015-25) – The working group adopted a proposal to require the following additional disclosures for each SCA investment other than insurance SCAs for year-end 2015 financial statements: "SCA balance sheet value (admitted and non-admitted) as well as information received from the NAIC in response to the SCA filing (e.g., date and type of filing, NAIC valuation amount, and whether resubmission of filing is required)." Prior to adoption, the disclosure was expanded to include an aggregate total of all SCAs (except 8.b.i entities) with detail of the aggregate gross value under SSAP 97 of both admitted and nonadmitted amounts.

Variable Annuity Captive Disclosures (2015-36) – At the Fall National Meeting, the working group adopted a new disclosure for 2015 financial statements for insurers which cede to variable annuity captives. The working group also expects to work on possible revisions to the hedging guidance in SSAP 86 and also consider an industry request for an expanded limitation on admitted deferred tax assets. See the summary of the Variable Annuity Issues Working Group for additional details.

Application of the Equity Method (2015-32) – The working group adopted proposed clarifications to paragraphs 10-12 of SSAP 97 to reflect the original intent of the guidance related to the equity method of accounting for SCA investments. At the request of interested parties, the paragraph was revised to clarify that amortization is required for statutory goodwill.

Insurance-linked Securities (2015-34) – The working group adopted for 2015 annual and audited financial statements a new disclosure on the use of insurance-linked securities, such as catastrophe bonds. At the suggestion of interested parties the disclosure was clarified for reporting entities receiving "possible proceeds as the issuer, ceding insurer, or counterparty of insurance-linked securities." A definition of ILS was also adopted.

Disclosures for High Deductible Policies (2015-35) The working group adopted a revised proposal to address the increasing credit risk with respect to high deductible policies such as workers compensation. The amended disclosure is as follows and is effective for 2015 annual and audited financial statements: "if the individual obligor is part of a group under the same management or control such as a professional employer organization, list the individual obligors, each of its related group members, and the total unsecured aggregate recoverables on high deductible policies for the entire group."

XXX/AXXX Reinsurance Framework RBC Disclosures (2015-53) – As developed by the PBR Implementation Task Force, at the Fall National Meeting the working group exposed for a short comment period a proposed disclosure for 2015 annual and audited financial statements of ceding companies subject to AG 48. When a shortfall exists per the XXX/AXXX Captive Reinsurance Consolidated Exhibit, the ceding company would be required to disclose certain RBC information. This disclosure was adopted by the SAP Working Group during its December 10 conference call, and during

the Financial Condition Committee's December 11 meeting. See the PBR Implementation Task Force summary for details of the disclosure requirement.
Asbestos and Environmental Exception Reporting (2011-45 and 2014-28) – In 2013, the working group adopted accounting guidance for SSAP 62R related to the Schedule F penalty for asbestos and pollution contracts that have duplicate coverage, which results in a decrease in the overdue liability when the requirements are met. However, the regulators have struggled for months to finalize the guidance and instructions for Schedule F; over the summer, the working group revised its position and supported "Option 2" for annual statement reporting with modifications to paragraphs 66-68 of SSAP 62R to apply the guidance to unpaid losses as of December 31, 2015, as well as paid losses (which was permitted starting January 1, 2014).

During its September 24 conference call, the working group adopted the proposed SSAP 62R revisions as well as the proposed Schedule F revisions, which will be resubmitted to the Blanks Working Group for 2016 reporting. At the Fall National Meeting, as part of the historical documentation of the lengthy detailed discussions, the SAP Working Group exposed for a short comment period Issue Paper 153, Counterparty Reporting Exception for Asbestos and Pollution Contracts, which includes a new Appendix C; this appendix illustrates the reporting of such retroactive reinsurance on Parts 3-5 of Schedule F and a new Supplemental Schedule for Aggregation Regarding Retroactive Reinsurance for Asbestos and Environmental Exposures.

Synthetic GIC Model – During 2015, the Life Insurance and Annuities Task Force adopted changes to the *Synthetic GIC Model Regulation* (#695) to exclude contingent deferred annuities, revise the discount rate in the reserve calculation and several other changes. At the Fall National Meeting, the working group exposed these revisions to update the version of the model included in the APP Manual. These amendments were adopted by the working group during its December 10 conference call and December 11 by the Financial Condition Committee.

Foreign Currency Translation for Canadian Insurance Operations (2015-24) – The working group voted to adopt a revision to SSAP 23 to clarify that it was intentional to allow optionality for insurers to translate Canadian operations by either making a single adjustment to net assets or making line by line translations of financial statement items.

ASU 2015-04, Practical Expedient for the Measurement Date of An Employer's Defined Benefit Obligation and Plan Assets (2015-13) – The working group adopted the ASU with modification, which will revise SSAPs 92 and 102 to include guidance on interim re-measurement when a significant event occurs (but not allow these re-measurements to be used for year-end valuations).

SSAP 55 Disclosures (2015-29) – With respect to title insurance disclosures, the working group adopted modifications to the instructions to refer to "known claim reserves" (line 1 of the liabilities page) for the loss reserve development information.

SSAP 107 Revisions (2015-30) – The working group adopted proposed changes to the SSAP 107 risk adjustment receivables and payable guidance to be consistent with the guidance recently adopted for SSAP 54 related to Medicare Advantage and Part D receivables and payables.

Rejection of Recently Issued ASUs – The working group adopted rejection of the following U.S. GAAP guidance: *2015-03, Simplifying the Presentation of Debt Issuance Costs* (2015-10) and *ASU 2011-10, Derecognition of in Substance Real Estate* (2015-26).

Policy and Preamble Changes (2015-18 and 2015-28) The working group adopted a proposal to disband the Emerging Accounting Issues Working Group and bring the two members of EAIWG not on the SAP Working Group (Alabama and Connecticut) onto SAPWG. The process to issue INTs will be continued by the SAP Working Group. The regulators also adopted proposed revisions to the Policy Statements and the APP Manual Preamble to reflect this change and clarify other processes.

Exposure of New Guidance and Discussion of New and On-going Projects

Comments on exposed items are due to NAIC staff by February 5 unless otherwise noted.

Prepayment Penalties and Amortization on Callable Bonds (2015-04) – During the fall, the working group reached a consensus with interested parties with regard to two issues related to make-whole call provisions of callable bonds. The working group agreed to retain the accounting of prepayment penalties as net investment income (followed by a majority of insurers) and not require that make-whole provisions be considered in determining the timeframe for amortizing premium or discount unless the insurer is aware that the issuer expects to invoke the make-whole call provisions.

At the Fall National Meeting, the working group proposed amendments to SSAP 26 and SSAP 43R to clarify what portion of the proceeds reflects the

prepayment penalty. An appendix was also adopted with four examples of the application of the "yield to worst" amortization scenarios. Revisions to the annual statement and instructions are also being proposed to clarify the appropriate reporting of prepayment penalties within the investment schedules. The working group is requesting input from industry and regulators on the timing of these revisions and the appropriate effective date to allow entities to make any necessary changes to their systems, as well as consider whether historical IMR balances would need to be adjusted. The earliest effective date would be the first quarter of 2016, but companies are permitted to reflect this change in 2015 as an interpretation of the current guidance.

Short Sales (2015-02) – At the Fall National Meeting, the working group voted to expose Issue Paper 152, Short Sales, for comment, which would revise SSAP 103. The issue paper provides guidance for situations in which state regulations do not prohibit, or otherwise provide specific guidance for short-sale transactions. The issue paper proposes deviating from U.S. GAAP and would require a short sale to be recorded as a negative asset in the balance sheet. Guidance is also provided for short sales supported by a securities borrowing transaction. The proposed effective date is for periods ending after January 1, 2016.

Fees Incurred for Salvage and Subrogation (2015-21)
At the Summer National Meeting the working group exposed for comment a requirement for fees to recover salvage and subrogation to be reported gross regardless of whether the fees are paid to third parties or are allocated internally. At the Fall National Meeting, the working group heard comments from insurers that this proposal is inconsistent with current guidance to record salvage and subrogation at net realizable value. In response the working group has asked the Casualty Actuarial Task Force for its views and also asked for comments as to whether explicit netting of subrogation recovery expenses is supported by regulators and industry.

Investment Classification Review Project (2013-36)
Since 2013, the working group has been reviewing the investment SSAPs to consider clarifications of definitions, scope, accounting methods and reporting guidance. At the Summer National Meeting the working group asked staff to begin work on a new issue paper that will include proposed adoption of the U.S. GAAP definition of a security and definitions for other debt-like investments that fall outside the "security" definition. That issue paper has not yet been released for comment.

Also at the Summer National Meeting, the working group exposed a comment letter from BlackRock proposing an alternative to the proposed use of fair value for investments in Exchange Traded Funds, using an amortized cost valuation methodology similar to that of other fixed income investments with multiple individual positions and fluctuating cashflows. During the working group's September 24 conference call, regulators and interested parties, including issuers of ETFs and software vendors, had an extensive discussion of the BlackRock proposal focusing on feasibility and other identified issues. The chair stated that he believes the "BlackRock proposal has merit, as it maintains consistency with regular bonds and provides a mechanism for small and medium-sized companies to be more diversified within the bond market." A representative from Blackrock noted that ETF data needed for the valuation proposal will be "public, auditable, free and available from day one."

As a result of this discussion, at the Fall National Meeting the working group voted to expose two options for Schedule D reporting to more clearly highlight investments in ETFs (SAPWG #2015-45). Option 1 proposes the inclusion of a new category/line number on Schedule D – Part 1; Option 2 proposes the inclusion of a new schedule, which would roll into the total of Schedule D-Part 1, and separately report SVO-Approved ETFs. After the working group concludes on a recommendation, the Blanks Working Group will also have to consider it; the expected effective date is January 1, 2017. The working group also directed NAIC staff to continue working with interested parties to address issues identified on the proposed measurement method for SVO bond-designated ETFs.

At the Fall National Meeting, the working group also exposed a separate ETF-related proposal (2015-49) which recommends a clarification to SSAP 97 that ownership of an ETF or mutual fund does not represent ownership in an underlying entity within the scope of SSAP 97, unless ownership of the ETF actually results in "control" of an underlying company.

Quarterly Reporting of Investments (2015-27) – At the Summer National Meeting, the working group agreed to develop an alternative proposal to requiring full investment schedules to be filed each quarter after hearing very strong industry opposition to the proposal. In National Harbor, the regulators exposed for comment quarterly reporting of electronic-only data as an NAIC supplemental filing which would include only the following four data elements: CUSIP, par value, book/adjusted carrying value (BACV) and fair value for all Schedule D investments. The chair stated that he agreed with

exposing the revised proposal but did not support requiring it at this time. Steve Johnson of Pennsylvania commented that he hoping all parties can reach a compromise to provide investment information that can be analyzed at the industry macro level.

Correction of an Error in SSAP 3 – As a result of feedback from the NAIC's Quality Assurance Function, the SAP Working Group exposed for comment proposed revisions to SSAP 3 to clarify that refiling or amending an annual or quarterly statement filing does not require domiciliary regulatory approval when the revisions are to correct "reporting errors" such as formatting, completeness, consistency and data validation errors. The working group sees these errors as separate from "accounting errors," e.g. mistakes in the application of accounting principles or oversight or misuse of facts.

5*/6* Securities (2015-41) – The VOS Task Force and the SAP Working Group are collaborating on consideration of whether to remove the SVO from the 5* process and have insurers self-designate all 5* securities held (i.e. unrated securities which are current on principal and interest). The SAP Working Group asked for feedback from industry as to whether this self-designation process would require any changes to statutory accounting. As a result of this new agenda item, the working group deferred action on a proposal for AVR companies to report SSAP 26 and SSAP 43R NAIC 5 designated bonds at the lower of amortized cost or fair value (2015-17).

Holders of Surplus Notes (2014-25) – At the Fall National Meeting, the working group agreed to two revisions to the recently exposed Issue Paper 151, *Valuation for Holders of Surplus Notes*: inclusion of impairment guidance for surplus notes and expansion of amortized cost accounting to include both NAIC 1 and 2 rated surplus notes. The proposed revisions are now expected to be effective December 31, 2016.

Definition of Notional Principal for Derivative Contracts (2015-51) – As a result of frequent questions and lack of a single uniform definition in the industry, the SAP Working Group is proposing adoption of a definition of notional as an amendment to SSAP 86 based on the Commodity Futures Trading Commission's definition of notional principal.

Clarification of Permitted Practice Disclosure (2015-52) – The SAP Working Group voted to expose for comment proposed amendments to SSAP 1 and Appendix A-205 to clarify that disclosure of all permitted and state prescribed practices that differ from NAIC is required, not just those that affect surplus or RBC. The proposal also calls for disclosure of the SSAP that covers the NAIC prescribed practice and the specific financial statement line item affected.

PBR Issue Paper (2015-47) – The working group directed staff to draft an issue paper and related SSAP for the adoption of principles-based reserving, and to work with both regulators and interested parties on its development, with an anticipated effective date of January 1, 2017.

Non-recourse Charity Loans (2015-31) – Based on research done by interested parties, the working group concluded that obligations issued by charitable organizations should not be automatically non-admitted and should be accounted for in accordance with SSAP 26 or SSAP 43R as applicable.

ASU 2015-09, Insurance, Disclosures about Short-Duration Contracts (2015-37) – Property/casualty and health interested parties' study group reported that they are continuing to develop a proposal to address the ASU disclosures for short-duration for statutory reporting. Input will also be necessary from the AICPA/NAIC Task Force with respect to compliance with U.S. GAAS OCBOA (other comprehensive basis of accounting) disclosure requirements.

Restricted Asset Subgroup Report

The subgroup met November 9 via conference call as it continued its discussion of repurchase and reverse repurchase agreements (collectively referred to as repo agreements). The subgroup had earlier concluded that additional disclosures about repo agreements should be collected before any accounting changes are considered again by the subgroup. Most of the conference call was a detailed review by NAIC staff of proposed disclosure templates for repo agreements, which had been prepared by staff after reviewing the 2014 Financial Stability Board Consultative Document "Standards and Processes for Global Securities, Financing Data Collection and Aggregation" and the disclosure information included in *ASU 2014-11 – Transfers and Servicing, Repurchase to Maturity Transactions, Repurchase Financings, and Disclosures*. Both the chair and NAIC staff reiterated the point that although the disclosure templates look "overwhelming," only a few of the FSB's data elements had been integrated into the proposed disclosures. The subgroup also included the FSB summary document in the meeting materials so that regulators and interested parties could consider whether collection of additional data elements would be helpful.

The disclosure data is expected to captured and aggregated so that regulators can better understand

the financial effect of repo agreements on the industry. The templates "are designed to provide aggregated information on the general classes of securities sold or purchased, the collateral pledged, and the securities that have been classified as restricted assets in response to the repo agreement" and were exposed for comment until January 29.

Aging and Revenue Recognition of Multi-Peril Crop Policies (2015-33) – At the Summer National Meeting, the working group asked for information from interested parties, the Crop Insurance Working Group and the USDA Risk Management Agency on revenue and receivables related to crop insurance. As a result of comments received, regulators and industry recognized the need to update the guidance in SSAP 78, which has not been revised since 2000. (The chair noted "it is time to clean it up and get it right.") The working group then directed NAIC staff to work with interested parties and regulators to develop recommendations to update SSAP 78 in the following areas: 1) use of the billing date for application of the 90-day rule for premium receivables; 2) define the "processing date" for premium recognition or update the term; 3) provide more specificity regarding the period of risk for purposes of earning revenue; and 4) develop a glossary of terms.

Weather Derivatives (2015-43) – As part of its "catch-up" review of Interpretations of the Derivatives Implementation Group for FAS 133, the working group voted to expose for comment incorporation of the GAAP definition of weather derivatives and adopt, with modification, *EITF 99-02: Weather Derivatives* to require these derivatives to be reported and valued consistently with other derivatives under SSAP 86.

The working group also exposed for comment a proposal to reject the following derivative EITFs as not applicable to statutory accounting (2015-48):

- EITF 98-10: Accounting for Contracts Involved in Energy Trading and Risk Management Activities
- EITF 98-12: Application of Issue 00-19 to Forward Equity Sales Transactions
- ETIF 99-01: Accounting for Debt Convertible into the Stock of a Consolidated Subsidiary
- EITF 99-03: Application of Issue 96-13 to Derivative Instruments with Multiple Settlement Alternatives
- EITF 00-7: Application of Issue 96-13 to Equity Derivative Instruments That Contain Certain Provisions That Require Net Cash Settlement if Certain Events Outside the Control of the Issuer Occur

ASU 2015-15: Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements 2015-40 – The working group proposed rejection of this guidance as an amendment to SSAP 15.

Emerging Accounting Issues Working Group

INT 15-01: ACA Risk Corridors Collectability
The working group held conference calls October 19 and November 5 to address the recent notification from HHS that risk corridor receivables of $2.87 billion exceed payables of $362 million. As a result, there will be a proration for the 2014 benefit reporting year of 12.6%; 2014 shortfalls would be covered by future year collections. NAIC staff noted that there has been diversity in practice among health entities regarding the accrual of 2014 risk corridors receivables for the first two quarters of 2015. Some entities did not accrue material amounts for the risk corridors receivables, while others appear to have accrued the full amount of funds estimated to be received. At the conclusion of the October 19 call, the working group exposed a tentative consensus on four issues for a short comment period, which includes a requirement for companies to impair through the income statement any recorded risk corridor receivable in excess of the 12.6% proration amount.

At the November 5 conference call, the working group reviewed six comments letters, many of which objected to the requirement to impair risk corridor receivables in excess of 12.6%. The chair of the working group stated that he had changed his mind and it would be better to treat amounts above 12.6% as nonadmitted assets to avoid unintended consequences of income statement impairment; other members of the working group agreed. They also agreed that the decision to impair the assets versus non-admit is a judgment decision that should be left up to the reporting entities. Below is a brief summary of the final consensus of the working group.

Issue 1: Determining the Amount of Impairment – Any impaired amount would be based on the facts and circumstances and is required to be evaluated at each reporting period by management.

Issue 2: Nonadmittance – 2014 risk corridor receivables in excess of the 12.6% proration amount which have not been written off for impairment, and have a reasonable expectation of delayed recovery shall be nonadmitted.

Issue 3: Timing of Impairment or Nonadmittance Recognition – Any adjustment to receivables would be a Type I subsequent event reflected in the 2015 third quarter filing.

Issue 4: Accrual of 2015 and 2016 Receivables –Risk corridors receivables for the 2015 and 2016 benefit years estimated in accordance with SSAP 107, paragraphs 56.b and 56.e are nonadmitted 1) until such time that the prior benefit year is paid in full and 2) until additional proration amounts are confirmed by HHS or other information of a sufficient nature supports that collectability is probable and reasonable.

New Disclosures for ACA Risk Corridor Receivables (2015-54) – The SAP Working Group exposed for comment until January 15 proposed new disclosures related to risk corridor receivables starting with the first quarter 2016 statement (with data capture expected for the 2016 annual statement). The following information is proposed to be disclosed for risk corridors balances by program benefit year: estimated amount to be filed or final amounts filed with the federal agency; amounts impaired or amounts not accrued for other reasons (not withstanding collectability concerns); amounts received from the federal agency; asset balance gross of nonadmission; nonadmitted amounts; and net admitted assets.

Principles-Based Reserving Implementation Task Force

The task force met September 30 and in National Harbor and discussed the following issues and projects.

PBR Adoption by States and "Substantially Similar" Considerations
With the adoption of PBR by California, North Carolina and Wisconsin this fall, progress has been significant. As of the Fall National Meeting, 39 states have adopted the principles-based reserving requirements, which represents 72% of direct U.S. premium. Massachusetts is currently considering adoption which would meet the 75% of premiums requirement and eight additional states plan to discuss PBR in their spring 2016 sessions, which would exceed the 42 state minimum requirement. As a result, the task force is still recommending the use of January 1, 2017 as the earliest probable PBR Valuation Manual effective date, which now seems much more likely.

During its September 30 conference call, the task force discussed comments on its proposed Plan to Evaluate Substantially Similar Terms and Provisions to Determine the Valuation Manual Operative Date. Comments focused on the meaning of the phrase "substantially similar' and considerations when a state has adopted a small company exemption that is different from the Valuation Manual's exemption. The task force concluded that "substantially similar" would be such that an objective third party would agree. The Plan also notes the following: "The interpretation of the phrase "substantially similar terms and provisions" under these guidelines is solely focused on the legal determination within the Standard Valuation Law. The F Committee will continue to utilize their policies and procedures which could result in a different view of accreditation for a state that was or was not counted for determination of the VM Operative Date."

With respect to a state having a higher threshold for the small company exemption and potentially exempting more companies, the Plan was amended to state that such higher threshold will not automatically exclude a state's laws as being substantially similar but will trigger additional analysis. At the Fall National Meeting the task force adopted the November 10 draft of the revised Plan.

Valuation Analysis Working Group
The task force adopted the VAWG Process & Procedures Manual during its September 30 conference call, which was developed and adopted by the PBR Review Working Group. The VAWG will support member states in their review of PBR.

PBR Pilot Project
See the summary of the PBR Review Working Group for discussion of the pilot project.

PBR Experience Reporting Framework
The task force heard an update from NAIC legal staff on data collection and dissemination under PBR. The task force and the NAIC had at first thought that a few states could gather the necessary data but have concluded that there are too many challenges with this approach. As a result, the NAIC or an affiliate will service as experience data collector. Such experience data submitted by individual insurers would be owned by those insurers and treated as confidential data. The data would be reported using a uniform template and the NAIC would collect and store the data in a separate database. Data would be submitted annually by September 30 and compiled to create the annual public industry tables. NAIC staff hopes to have a formal proposal in January.

XXX/AXXX RBC Disclosures
During its September 30 conference call, the task force discussed and then exposed for comment a proposed new disclosure for 2015 financial statements when an RBC shortfall exists in the

XXX/AXXX Captive Reinsurance Consolidated Exhibit. After making revisions to the proposed disclosure to reflect comments received, the task force adopted the disclosure in National Harbor and forwarded it to the SAP Working Group, who exposed it subsequent to the Fall National Meeting. The disclosure requires a ceding company with captives which have RBC shortfalls to disclose the following:

- Name of the captive and the dollar amount of the risk-based capital shortfall

- Total Adjusted Capital for the current year, as reported in the Five Year Historical Data page of the annual statement, along with the sum of total adjusted capital, plus the total of the RBC shortfalls disclosed above, and

- For each reinsurer for which a non-zero Primary Security Shortfall is shown on the XXX/AXXX Reinsurance Primary Security Shortfall by Cession Exhibit, list the name of the reinsurer and the amount of Primary Security Shortfall. Also disclose the total shortfall from that exhibit across all reinsurers.

The SAP Working Group adopted this disclosure for 2015 financial statements during its December 10 conference call.

Capital Adequacy Task Force

In addition to receiving reports from its six working groups and subgroups in National Harbor, the task force discussed a recent revision to its 2015/2016 working agenda. The task force has concluded that the catastrophe risk charge will be informational only for "at least" another year i.e. through 2016.

Life Risk-Based Capital Working Group

The working group met via conference call October 16 and at the Fall National Meeting and discussed the status of the following projects.

XXX/AXXX Reinsurance Framework RBC

The working group and the ACLI are continuing work on an approach to incorporate consideration of AG 48 Other Securities into either a stand-alone proposal or into the calculation in the RBC shortfall. A conference call has been scheduled for January 22 to discuss this project and consider other possible changes to XXX/AXXX RBC proposals adopted in 2015. The ACLI noted that analysis of 2015 RBC filings may not be informative since there were very few transactions in 2015 that are subject to AG 48 and the XXX/AXXX RBC requirements.

C-3 Phase II/AG 43 (E/A) Subgroup Update

This joint subgroup was initially charged with evaluating the overall effectiveness of capital and reserve requirements for variable annuities and presenting recommendations to improve the effectiveness of those requirements. The subgroup has struggled to address its broad charge and following the Summer National Meeting began to follow the activity of the new Variable Annuities Issues Working Group, which is analyzing some of the same issues that the subgroup has considered, in hopes of leveraging that work. At the Fall National Meeting the subgroup chair reported that its original charge had been moved to the VA Issues Working Group and that the subgroup had a new charge to develop and recommend changes to C3 Phase 2 and AG 43 for 2017 adoption that implement the Variable Annuities Framework. (See the summary of the VA Issues Working Group for additional discussion of the Framework.)

On November 24, the Life RBC Working Group, C-3 Phase II/AG 43 Subgroup, Life Actuarial Task Force and VA Issues Working Group held a joint conference call to discuss the quantitative impact study being performed by Oliver Wyman. The purpose of the call was to ensure that the represented groups all have a consistent understanding of the study objective, which is to assess the effectiveness and impact to companies of the recommended changes in the Framework. Key points of discussion were (1) one goal is to ensure that there is no longer a situation where the total asset requirement is less than the reserve and (2) the Academy's position is that the working reserve for these calculations should be zero. The subgroup expects to follow this activity and work on its charges concurrently with execution of the quantitative impact study. The C-3 Phase II/AG 43 Subgroup will make decisions on how the actual changes will be made to the RBC formula.

Longevity Risk Subgroup

At the Fall National Meeting, the working group heard a presentation from its New Jersey representative on longevity risk. Key points were that some/many jurisdictions include this risk in their regulatory capital models, the U.S. statutory framework needs to explicitly account for this risk "through reserves and/or RBC," but more analysis is needed on key issues. The subgroup is looking for additional members in addition to NJ and NY and hopes to make significant progress by July 2016. Longevity risk will be discussed during the Life RBC Working Group's January 22 conference call.

Stress Testing Subgroup Update
The subgroup did not meet this fall. A conference call will be scheduled in early 2016 for a "brainstorming session" on what should be the next steps with respect to the subgroup's charge to evaluate RBC in light of principle-based reserving.

Operational Risk
At the Spring National Meeting, the working group agreed to take on a project to make operational risk more granular for the life RBC formula. With the departure of the former chair of the working group, the regulators decided to analyze the data provided in the current informational only filing for a few years and then decide if a more sophisticated approach is warranted.

Investment Risk-Based Capital Working Group

The Investment RBC Working Group held conference calls on September 8, September 25, October 9, and October 27 and met at the Fall National Meeting and discussed the topics below. (The September 25 and October 9 calls were regulator-only meetings during which the working group discussed with S&P representatives its global ratings scale to better understand the comparability of ratings across different asset classes.)

Corporate, municipal and sovereign debt bonds
The working group revisited the granularity of bond factors at the Fall National Meeting. The regulators continue to evaluate interested party comments whether the benefits of changing from six NAIC designations to fourteen or nineteen outweigh the associated costs. The working group presented the most significant benefits to be the following: smoothing out cliffs between rating categories, eliminating the use of average assumptions, and better alignment of capital with investment risk.

Although there are obvious benefits to increasing the level of granularity, there is less consensus on how significant the impact of a potential change would be since some interested parties believe that the approximations embedded in the current rating system are appropriate. Therefore, the working group requested further analysis and emphasized the importance of moving forward slowly and considering all consequences prior to implementation. The ACLI has suggested that 2018 be the earliest period that any changes to the number of designations be considered.

The working group also discussed whether the bond factor for corporate bonds should be applied to municipal and sovereign debt. The working group and the Academy noted that since the NRSROs consider risk differences among issuer types and RBC is based on ratings from NRSRO, no adjustment is necessary. Interested parties presented the working group with other analysis that suggests that separate factors might need to be applied because the NRSRO ratings do not sufficiently address the default risk associated with different asset classes. The working group requested additional analysis in this area and highlighted that there is limited historical data available for analysis since rating agencies did not restate default data prior to 2010 after the recalibration of municipal ratings.

During a subsequent conference call December 17, the working group heard a presentation from AFLAC on recommended revisions to the proposed RBC C-1 factors for sovereign debt.

Bond Methodology Presentation
As a result of the ACLI's and other interested party comments on the AAA's proposed bond factors, the Academy gave verbal responses to questions related to discount rates, risk premium offset and the use of a greatest loss construct. The Academy's representative stated that they will be providing written comments on all issues in advance of a future meeting. The chair reiterated her view that the Academy's recommendation is based upon a "careful and detailed analysis," using Moody's default data back to 1920, S&P recovery data to 1987 and economic data to 1983 from "highly regarded organizations." The data was subjected to a 10,000 trial simulation to a 95% confidence level.

Real Estate
The working group previously exposed a revised proposal developed by the ACLI (dated August 7, 2015) which would decrease the current base factor for all real estate from 15% to 8.5%. Other key components of the revised proposal are: (1) a simplified treatment of encumbrances through a credit to the real estate's total carrying value; (2) an adjustment to the factor for the difference between market value and statutory book value; and (3) a proposed factor for Schedule BA real estate of 12.75%, i.e. 50% higher than Schedule A real estate. During its September 8 conference call, the chair of the working group suggested that a "higher cushion in the real estate factor for these items, perhaps 10%" might be appropriate because of challenges presented by the revised proposal related to determining fair value for real estate, treatment of encumbrances, and diversification (or lack thereof) in insurance company real estate portfolios.

During its October 27 conference call, the working group reviewed four comment letters on the proposal. The AAA's C1 Working Group noted its support for a lower real estate charge but raised issues with respect to whether the data "adequately captures the extreme fluctuations in the real estate market," the assumption that the base factor reflects an offset to real estate losses for the investment income received, and an adjustment to the base factor for the difference between current market value and statutory statement value. There was no discussion of the real estate proposal at the Fall National Meeting.

P/C RBC Considerations
At the Summer National Meeting, the working group requested that the AAA analyze how the suggested changes to C-1 factors for corporate bonds in the life industry would impact P/C companies. The Academy reported that bond factors do not have a significant impact to P/C RBC because the large majority of bonds are government bonds with low reserve factors. Therefore, based upon the immateriality of the impact, the Academy believes that no changes are necessary. However, if changes are to be implemented, based upon differences in the RBC formulas between life and P/C companies, the Academy recommends three principal adjustments to the Life RBC C-1 factors should address: the shorter duration of P/C portfolios, the absence of a provision for expected credit losses in P/C reserves, and the difference whereby P/C RBC factors are prepared on a pre-tax basis while life RBC factors are calculated on an after-tax basis.

The working group is also exploring the common stock factor to evaluate whether a beta adjustment should be added to the P/C RBC formula.

Health RBC Considerations
In collaboration with the Academy, the working group continues to evaluate how its work related to asset risk should be considered in the health RBC formula. Although underwriting risk accounts for approximately 63% of risk for health companies, the working group has prioritized reporting on the historical development of the treatment of asset risk for health companies by the 2016 Spring National Meeting.

With respect to interested party views on the application of the life C-1 factors to the P/C and health RBC formulas, there are many who do not agree that the current factors need to be revised due to the much lower impact of invested asset risk on the overall P/C and health RBC formula results.

Operational Risk Subgroup

The subgroup held conference calls on September 14 and October 9, and met in a regulator-to-regulator session on October 26. During the conference calls, the subgroup discussed the analysis of the effectiveness of the proposed growth risk charge in operational risk. The 2015 Operational Risk charge will be an informational-only calculation, consistent with 2014.

Growth Risk Test Results
The subgroup heard an overview of the growth risk test results. Using 4 years of RBC data (2011 – 2014), the review compared the RBC impact of the existing growth risk charge to the proposed charge. The existing growth risk charge was evaluated "as is" within the R4, R5 and H4 risk categories. In order to isolate the impact of the proposed charge, the existing charge was removed from the data for each year and data for the proposed method using the informational factors was substituted as a separate risk category.

The P/C analysis noted the following: generally more companies triggered a growth risk under the proposed growth risk charge (except for in 2014) and there was no discernible pattern on which method generated a higher percentage of companies that ultimately reached an action level. On average, the existing method produced a higher percentage of total RBC (exception was 2014) and appeared to move within a fairly narrow range. There did not appear to be a material difference in the average size (premium volume) of companies that was impacted by either growth risk charge.

For health entities, more companies triggered under the proposed growth risk charge. There was nominal difference in which method generated a higher percentage of companies that ultimately reached action level, but the absolute number was clearly higher for the proposed method. Companies triggering the proposed growth risk charge appeared to be larger on average (premium volume) than companies triggering the existing growth risk charge. This was more pronounced in 2014.

Overall, the proposed method for P/C RBC did not produce significantly enhanced results compared to the existing method. As such, NAIC staff noted that there does not appear to be an apparent reason to abandon the existing method in favor of the proposed method. For health, the analysis was less clear in direction, and the substantially higher than average recent growth across the industry led to an initial conclusion by NAIC staff that 2015 data should be analyzed before deciding on the

methodology. The chair requested for both P/C and health data on “false negatives” be broken out for each method. An industry group suggested that for the health data, the average size of companies impacted by each method be compared to the median size in order to obtain a clearer picture of the differences between the methods for growth risk. The subgroup will continue its discussion in future calls.

Property/Casualty Risk-Based Capital Working Group

The working group met by conference call on September 30 and in National Harbor to discuss the following projects.

Type 7 Investment Subsidiaries (2014-29-P)
The working group continued its discussion of a proposal to simplify the RBC charge for the ownership of investment affiliates (affiliate Type 7) to be a fixed factor times the carrying value of the common stock, preferred stock and bonds. The proposal was previously exposed at the 2014 Fall National Meeting and was not adopted at the Spring National Meeting amidst concerns that a fixed factor would result in less accurate reporting.

The working group subsequently discussed and exposed another option which is to consider additional worksheets to list all the investments owned by the subsidiaries. A working group member raised concern that because the factors and framework of the second option are based on the structure of the asset concentration page, verifying the reporting information and different accounting basis and reporting format between the reporting company and the investment affiliates pose challenges. The working group agreed not to take any action and will defer action until the Investment Risk-Based Capital Working Group has an opportunity to review the matter.

Industry Average Factors (2015-20-P)
The working group discussed alternative approaches effective 2016 for computing the industry average development factors (Line 1 of PR017) and industry average loss and loss adjustment expense ratios (Line 1 of PR018). It was noted that the current approaches are subject to distortion as a result of intercompany pooling arrangements. The working group chair agreed to have the Academy review the matter and provide findings. No action was taken by the working group.

Catastrophe Risk Subgroup

The subgroup met by conference call on September 15, September 30, and October 15 and met in person at the Fall National Meeting to discuss its projects.

Company Models
During the regulator-to-regulator sessions on September 15 and October 15, the subgroup discussed the possibility of adding instructions and interrogatories for determining that a company’s internal model is an appropriate basis for the catastrophe risk charge. The subgroup also discussed a letter from the Missouri Department of Insurance regarding the Swiss Financial Market Supervisory Authority’s review of Swiss Re’s internal natural catastrophe model. The subgroup intends to continue discussing this matter in future regulator-to-regulator conference calls.

Catastrophe Risk Charge Exemption (2015-21-CR)
The subgroup discussed a proposed interrogatory for 2016 which would allow companies to provide information on how companies define the New Madrid Seismic Zone to determine if they qualify for exemption from the requirement to report their earthquake exposure on PR027. The subgroup exposed the proposal for comment. No comments were received and the proposal was adopted at the Fall National Meeting.

Presentation of Catastrophe Charges (2015-19-CR)
The subgroup discussed a proposal to simplify the presentation of the catastrophe charges for multiple perils effective 2016. The proposed changes will introduce a separate page combining all the catastrophe risk charges into the Rcat component. The current R6 and R7 will be replaced by this new component in the covariance adjustment formula. The proposal was exposed and subsequently adopted at the Fall National Meeting; no comments were received.

Comment Letter
The subgroup discussed a comment letter from an insurer regarding the effect of income taxes and reinstatement premium on the RBC calculations, which are not currently considered in catastrophe risk, and the guidelines on calculation of recoverable amounts with zero credit risk. The comment letter noted that if the ultimate goal is to determine the net impact on RBC of reported storms, then the financial impact should be reported net of tax. The comment letter also noted that to determine the true financial impact for companies that purchase reinstatement premium, the retention reported in PR027 should include the additional reinstatement premium that by contract is to be withheld by the reinsurer for

reinstatement of the cover. The comment letter requested for reconsideration of guidelines on the calculation of recoverable amounts with zero credit risk which should conceptually be similar to Schedule F penalty. The subgroup discussed the comments raised and agreed to look into the premium reinstatement issue. The subgroup will not pursue the income tax issue as the matter had been discussed at length previously.

As it relates to the reinsurance recoverable factor, the Reinsurance Association of America noted that the logic of using a selected 4.8% factor is based on the R3 factor applied to reinsurers with at least an A- rating and with appropriate cushions for other than credit risk. Subgroup members and interested parties were asked by the chair to follow the development of the R3 credit risk charge and provide feedback in future calls.

Other Catastrophe Risks
The subgroup continued its discussion of other catastrophe risks for possible inclusion in the P/C RBC formula. The subgroup noted that it has always been its intent to determine if risk charges for any other catastrophic perils such as tornado, wildfire, and terrorism should be added to the P/C RBC formula. The subgroup plans to continue its discussion in future meetings.

Catastrophe Risk Modeling Presentation
At National Harbor, the subgroup heard a presentation from AIR Worldwide on the state of modeling and scope of modeled perils. The presentation focused on the following matters: 1) which catastrophe peril losses are significant from a solvency standpoint; 2) how widespread the use of catastrophe models for given perils is; 3) how complex each catastrophe model is; and 4) the level of reliability and robustness of each model. Following the presentation, the chair inquired if AIR has any publications to compare the one in 100-year event for each peril. AIR noted that this information was included in a white paper issued last year and the document will be shared with the subgroup. No action was taken by the subgroup on this matter.

Health Risk-Based Capital Working Group

The working group met by conference call on October 6, October 19, November 10, and December 9 to discuss the following issues.

Medicaid Pass-Through Payments (2015-26&27-H)
During the October 6 regulator-to-regulator session, the working group heard a presentation on Medicaid pass-through payments from Mercer Health and Benefits and the New Jersey Department of Human Services. The matter appears to be more complex than was originally anticipated because the treatment of payments varies widely among the states, making it difficult to address the treatment of these items within the health RBC formula. Some payments are quite large and in some states, are treated as premiums for premium tax purposes and for discounting purposes. Currently, the payments are included in the underwriting risk portion of the formula and incur a higher charge even though the payments are not a true underwriting risk.

The working group discussed an NAIC staff recommendation to add a new column to the Underwriting Risk – Experience Fluctuation Risk page (XR012) for Medicaid pass-through payments to address the premium tax component within the underwriting risk portion of the formula using a factor charge similar to the business risk component which is 2%. The working group noted that the recommendation would be appropriate but it is too late to make the change for 2015. As such, the NAIC staff recommended adding clarifying language to the guidance to allow companies to consider the payments as subcapitations and subject to the 60% managed care adjustment for 2015, which reduces the RBC effect of the amounts being considered premium.

Following the discussion, the working group directed NAIC staff to draft guidance for page XR017 for 2015 and changes to XR012 for 2016. During the December 9 conference call, the working group reviewed the draft proposals for 2015 (2015-27-H) and 2016 (2015-26-H), and exposed both for a comment period ending January 8.

2016 Underwriting Risk Instructions (2015-14-H)
The working group discussed a previously exposed proposal to add a new column to separate other non-health business from other health business which is consistent with the reporting in the Annual Statement Analysis of Operations page. Two editorial comments were received and the working group adopted the proposal. Subsequent to the adoption, the chair noted that the working group did not address the factor to be used in the other non-health column. Additionally, a question was raised whether the 13% factor in the other health column should be reviewed because non-health business is now excluded. The working group agreed to continue its discussion in future calls.

Health RBC Drafting Group
Following the Summer National Meeting, the Health RBC Drafting Group was formed to assist in determining the impact of recommendations on asset risk from the Investment RBC Working Group.

The drafting group's responsibilities include researching and identifying for documentation purposes the rationale for different treatment of invested asset risk on the health RBC formula compared to the life RBC formula. The drafting group has noted that the health RBC formula was based on the P/C RBC formula and that there has not been a lot of analysis on the methodology and factors used in the health formula using health data. The drafting group intends to review past NAIC proceedings and minutes.

During the December 9 conference call, the chair discussed converting the drafting group into a technical group to work with the Academy's Health Solvency Work Group. No motion was needed to expand the responsibilities of the drafting group. The plan is that both the technical group and the Health Solvency Work Group will hold joint calls, resulting in a report to the working group at the Spring National Meeting.

Risk Corridor Receivables
The chair reviewed the October 1 HHS announcement that the 2014 risk corridor payments would be prorated to approximately 12.6%, resulting in a significant shortfall between payments and receipts. The chair noted that some companies may trigger an RBC action level because of the non-receipt of an accrued receivable. The chair inquired if there should be changes to the health RBC formula to capture what has occurred and what may occur in the future due to the significant impact to insurers' solvency, noting that, at a minimum, the risk adjustment and risk corridor sensitivity test should be changed. A working group member stated that even if it is not a capital issue, it could still be a cash flow issue for companies. The working group will continue its discussion in future calls.

Valuation of Securities Task Force

The task force held three interim conference calls and met in National Harbor and discussed it current agenda of topics.

RMBS & CMBS Modelling
After discussions at several meetings, the task force adopted the 2015 macroeconomic assumptions, scenarios, and risk ratings to be applied to the 2015 financial modeling for RMBS and CMBS as recommended by the Structured Securities Group. The SSG emphasized that the proposals are designed to balance possible economic future outcomes in response to comments from interested parties that the model was overly pessimistic. Additionally, as the NAIC moved to a new vendor, BlackRock, for modeling of both RMBS and CMBS for 2015, insurers received files with all securities remodeled using the new BlackRock model. There have been no significant issues in moving to BlackRock and the SSG expects final results to be delivered on a timeline similar to last year.

Derivative Instrument Model Regulation
The task force heard a final report on the study to determine whether the *Derivative Instruments Model Regulation* should be revised. The NAIC and the ACLI concluded that no modifications are necessary because there are no new derivatives risks that "require new processes, systems or personnel requirement or an exacerbation of known credit, operational, market or other risk that require more specialized processes, systems or personnel." The report also noted that insurers are not using derivatives differently since the adoption of the *Derivative Instruments Model Regulation*. The task force released the report for a comment until January 24.

The task force also received a report from the Investment Analysis Office on whether the *Derivative Instruments Model Regulation* should be retained as a national or uniform standard. Although only thirteen states have adopted the regulation, insurers domiciled in those states represent 96% of total U.S. insurer derivatives exposure. The task force released the IAO's report for comment until January 24.

NAIC Bank List
The task force received a report from the SVO on expanding the Bank List to a list of Qualified U.S. Financial Institutions, which would be used when evaluating letters of credit as collateral in reinsurance arrangements. Consistent with previous discussions, the SVO reported that the historical default rates of nonbank financial institutions (NBFIs) are nearly identical to banks and that the business models are also very similar. The SVO's proposed amendment allows for NBFIs to apply as letter of credit issuers. If added to the list, SVO would monitor the NFBI through an evaluation of its credit quality in a manner that is consistent with other institutions on the list. The working group exposed the report for comment until January 24.

Reporting Exceptions
Annually, the SVO releases a report identifying the volume of securities that are flagged as reporting exceptions. While the list of reporting exceptions (4,889 using December 2014 data) includes some securities that were inappropriately reported as filing exempt, approximately 80% of the securities were explained rather quickly to be in compliance with SVO requirements. The most frequent

explanations are that the securities have in possession private letter ratings, the securities have Bloomberg-reported ratings, or the securities were bank loans. The SVO continues to explore opportunities to more effectively share this data with regulators and interested parties to help reduce the number of exceptions identified. The task force also indicated that it must identify a solution to transmit data to the SVO that verifies that securities identified as exceptions are in compliance.

Quality Assessment of Walgreens credit tenant loans

Insurers are required to file an audited financial statement to get an updated NAIC designation for a credit tenant loan. Recently, a corporate merger and reorganization of Walgreen Co., which is now a wholly-owned subsidiary of Walgreens Boots Alliance Inc. (WBA), created an issue because audited financial statements of Walgreen Co. are no longer available. Therefore, a direct financial assessment of Walgreen Co. so that the credit tenant loans can be reported as Schedule D bonds is no longer possible. Multiple insurers have raised this issue and the SVO has proposed that it use the audited financial statement of the credit tenant's parent for its evaluation. The task force approved the SVO using analytical discretion in this very specific case and highlighted that if a similar situation arises, SVO will raise it to the task force for consideration.

Filing Process Modernization

The SVO continues to review its filing rules prior to development of a new electronic filing system. During its November meeting, there was active discussion between NAIC staff and interested parties on a number of specific recommendations to help reduce the backlog of securities to be valued by the SVO late in the year. The NAIC staff's proposal that the number of days insurers have to submit an initial filing be reduced to less than 120 days was met with resistance because of the effort required to gather the necessary information. Interested parties also recommended that the fee structure be modified so that companies pay for all securities on an annual basis. Other proposed changes discussed relate to eliminating the exclusive 30-day period to complete a filing during the authorization-to-file period, the time period that insurers have to provide missing documentation within the InfoReq process, and the Z rule that allows for an insurer to self-designate if the SVO has not assigned a designation by year-end. The task force encouraged continued dialogue and indicated the goal is to have specific proposals in 2016.

Securities Listed by SVO

The task force has been working with the Reinsurance Task Force to develop a consistent interpretation of the phrase "securities listed by the Securities Valuation Office." In previous meetings, the task force discussed a proposal to expand the collateral definition and delineate between an investment security, and a "regulatory transaction," or a funding solution to a company/state-specific regulatory issue. The proposal documents the SVO's compilation function for securities and allows investment securities to be listed as acceptable collateral, but will exclude regulatory transactions. The task force adopted this proposed amendment to the P&P manual during an October conference call.

International Accounting Standard Considerations

The task force has been reviewing whether financial statements prepared in accordance with international accounting standards without reconciliation to U.S. GAAP can be submitted to the SVO for analysis due to changes in modifications of UK GAAP and requests from interested parties to expand the definition to include accounting frameworks specific to other jurisdictions. During the Fall National Meeting, the task force adopted an amendment to add UK FRS 102, which extends to Irish companies, and Dutch GAAP to the list of National Financial Presentation Standards (NFPS). The task force continues to review whether Italian GAAP should also be approved as a NFPS.

SEC Changes to Money Market Fund Rules

In 2014, the SEC adopted changes to money market fund rules, including a rule prohibiting institutional prime funds from using stable net asset value of $1.00 a share. A stable NAV is a requirement for the bond classification of money market funds. Therefore, use of a floating rate would preclude the MMFs from inclusion on the Class 1 List. The task force has been monitoring the impact of the change. As expected, there has not been a significant drop-off to date since the change does not go into effect until October 14, 2016. Based upon the pending change, the task force proposed the list be renewed in January and set an expiration date for the list of September 30, 2016; SVO staff will prepare the proposed amendment to the P&P Manual for discussion at a later meeting.

Other Adopted Amendments to P&P Manual

The task force adopted three other amendments to the SVO P&P Manual during its November meeting. One amendment clarifies that three years of cash flow statements are required when filing financial statements that are prepared in accordance with NFPS. The task force also adopted an amendment to delete an instruction that insurers manually insert RBC for common stock when reporting mandatory convertible securities and expand the scope of the definition of mandatorily convertible securities to include preferred stock. Another adopted amendment clarifies that insurers are not required

to file a private common stock security with the SVO valuation unless it chooses to have the SVO provide a valuation of that security.

Group Solvency Issues Working Group

The working group met via conference call on November 11 and received an update on IAIS activities. During the IAIS meeting held on August 31, the regulators discussed revisions to Insurance Core Principle 23, Group Supervision, ICP 25, Supervisory Cooperation and Coordination, and the ICP Glossary, as a result of comments received; the revisions were ultimately adopted during the November 11 meeting of the IAIS Executive Committee. The revisions to ICP 23 mainly included clarifications of the role of group-wide supervisors and the applicability of the ICP to the insurance group. ICP 25 was updated with minor changes; however additional edits may occur in 2016.

International Insurance Relations Committee

The International Insurance Relations Committee met by conference call in August and November and met in National Harbor to discuss the following topics.

Group Capital Calculation
At the Fall National Meeting, the committee discussed and then adopted the recommendation from the ComFrame Development and Analysis Working Group for the NAIC to develop a group capital tool. See the summary of the ComFrame Working Group below for additional discussion of that recommendation.

IAIS Update
The committee heard detailed updates of IAIS activities including recent meetings and development of the International Capital Standards. Those updates are summarized in the meeting of the ComFrame Working Group below.

NAIC Assignment Plan for Select U.S. FSAP Recommendations
During its November 2 conference call, the committee adopted the Financial Sector Assessment Program Assignment Plan, which assigns ownership of the IMF's recommendations for how the states, the NAIC, FIO, and Federal Reserve could improve the U.S. state-based system of insurance supervision. The committee emphasized that many of the recommendations are already being considered in various on-going projects (e.g. group capital considerations and evaluation of the scope of examinations). The chair noted that the NAIC does not agree with some of the recommendations, e.g. requiring ORSA reporting for all insurers regardless of size or premium volume, and will not "necessarily adopt or pursue a recommendation beyond the consideration process."

Forum on Group Supervision and Transatlantic Cooperation—EU-U.S. Insurance Project

Following the last session of the Fall National Meeting, the EU-U.S. Insurance Project met and continued the dialogue on group supervision and transatlantic cooperation. The meeting was conducted in three sessions that included panelists from U.S. and EU regulatory bodies, as well as industry executives. The panelists provided insight and continued their discussion of various group supervision topics, including the impacts of ORSA, Solvency II and reinsurance passporting and covered agreements.

The EU-U.S. Insurance Project's Technical Committee on Group Supervision provided a summary of 2015 activities. Meetings were held with members of state regulators, the FIO, the NAIC, the European Commission and the European Insurance and Occupational Pensions Authority (EIOPA), where parties shared insights and status of their respective group-wide supervisor regulation. This included the EIOPA and the NAIC presenting on supervisory colleges statuses, as well as the status of ORSA and corporate governance. Overall the view was expressed that, based on the information exchanges performed, the objectives and approaches of EU and U.S. supervisory regulation are largely aligned.

It was noted that what remains to be seen will be how U.S. firms will be viewed by EU jurisdictions under Solvency II. US regulator participants in the discussion focused on steps taken to improving group-wide supervision, as well as having 32 states adopting the *NAIC Credit for Reinsurance Model Law*. Industry panelists were broadly supportive of the risk assessments included in ORSA. However on the reinsurance topics, they also expressed the view that a federal U.S. covered agreement would be beneficial. EU representatives did not comment as to whether these actions are viewed as equivalent to their own regulation. The NAIC continues to oppose a federal covered agreement proposal because it could pre-empt state law and undermine the current regulatory structure in the U.S.

ComFrame Development and Analysis Working Group

Development of a Domestic Group Capital Standard
During the fall, the working group continued its deliberations of the NAIC Group Capital calculation. The working group reiterated the objective of a U.S. group capital standard is to provide a quantitative measure for group risks. It is not intended to represent a group capital requirement, but rather a tool for supervision of all U.S.-based groups.

During the Summer National Meeting, the working group discussed three proposed approaches, which are RBC aggregation, statutory consolidated filing for RBC, and GAAP consolidated filing for RBC-Plus. As deliberations continued during an interim meeting held in Atlanta September 24, the preference of the working group, as well as feedback received from interested parties, was to pursue an RBC aggregation approach.

During its October 30 conference call, the working group approved a three-page concept paper/ recommendation for the development of an NAIC group capital calculation. The recommendation included the working group's basis for selecting the RBC aggregation approach, as well as the importance to stay abreast of other capital developments occurring at the national and international levels. The chair stated that any feedback received to date, particularly concerns over the interaction with other capital standards (such as a proposed standard from the Federal Reserve), and scope of the calculation will be provided to the Financial Condition Committee, which will be responsible for assigning the development of the group capital tool to one of its existing working groups or a newly formed group. The chair also noted that that the NAIC has been meeting with FIO and Federal Reserve, and will be "working collaboratively" with them and the IAIS on the group capital calculation.

The Financial Condition Committee will be charged with further development of the approach and faces a number of critical challenges as it moves forward with the initiative. The ComFrame Working Group explicitly identified the following challenges in its recommendation: (1) the committee must determine whether the calculation would be necessary for all groups or if it does not add value for specific segments of groups and should not be required; (2) the committee must determine how to incorporate non-RBC filers and non-insurance entities in the calculations; (3) the committee must evaluate differing levels of conservatism between different accounting standards that drive the RBC calculations; (4) the committee must determine whether holding company's senior debt will be counted as available group capital consistent with the treatment of surplus notes for insurance entities; (5) the committee must assess and define treatment of intercompany transactions for eliminations; and (6) the committee should consider how stress testing could complement a group capital calculation. Although the Financial Condition Committee will head up the development of the group capital tool, the ComFrame Working Group will be reviewing proposed documents and providing input.

During the Fall National Meeting, the International Insurance Relations Committee adopted the group capital proposal.

ComFrame and IAIS Update
During the Fall National Meeting, the working group heard an update on the status of field testing of the IAIS's Common Framework for the Supervision of Internationally Active Insurance Groups. The IAIS is reviewing the 2015 data from its second round of quantitative field testing, but it was noted that it is too early to draw conclusions. The 2015 field testing documents have been made public on the IAIS' website. The focus of field testing in 2016 will be valuation, capital resources, design of risk charges, calibration levels and aggregation of risk charges.

During the IAIS recent annual general meeting in Marrakech, Morocco, Florida joined the IAIS Multilateral Memorandum of Understanding. Twelve other states are part of this group, which is chartered as a global framework for cooperation and information exchange between insurance supervisors. Several more states have applied to join this group and the committee encourages other states to consider application.

Also in Morocco, the IAIS adopted the initial methodology of the HLA (Higher Loss Absorbency for G-SIIs). The NAIC had previously submitted comments on HLA, which were focused on the importance of carefully evaluating the uplift associated with non-traditional and non-insurance business since consistently quantifying the risk of these businesses is difficult. The first version of the HLA was published on October 5 and will continue to be monitored for necessary refinements. This is further step toward the IAIS' path of requiring G-SIIs to hold qualifying regulatory capital in excess of the calculated BCR (Basic Capital Requirement) plus HLA amount beginning in 2019.

On November 3, the Financial Stability Board updated its list of G-SIIs. The nine companies identified are AIG, MetLife, Prudential Financial, Allianz, Aegon, Aviva, Axa, Ping an Insurance

Company of China, and Prudential UK. This list represents one addition (Aegon) and one removal (Generali) from the prior year list. The committee noted that the IAIS continues to focus on revising its G-SII methodology and analyzing the definition and considerations for non-traditional and non-insurance business.

Financial Stability Task Force

The task force met in National Harbor and heard updates on issues affecting domestic and global financial stability.

Insurance Risk: Systemic Implications
Professor Mary Weiss of Temple University provided an overview of academic literature on systemic risk including insurance. According to the authors cited during the discussion, traditional insurance activities are not influenced by economic cycles and do not contribute to systemic risk. Historically in the United States, the guaranty funds have played a significant role in controlling individual insolvencies within the insurance industry. However, Profession Weiss cautioned that an unprecedented crisis in the life insurance industry or significant cash runs on life insurers selling group annuities could create significant stress in the system. Although traditional activities do not present systemic risk, non-traditional activities that insurance entities engage in that may be systemic are securities lending, life insurer products with guarantees, asset-liability mismatching, reliance on short-term funding, financial guarantees, and trading credit default swaps.

The impacts of defaults within the reinsurance industry was also examined and determined to be insignificant. Research concluded that default on 100% of reinsurance recoverables by a top three global reinsurer would cause the insolvency of only 1% of global insurers.

During the presentation, the opportunity for assessing risks across insurance groups as opposed to legal entities was identified as an opportunity to further mitigate systemic risk. Additionally, it was noted that regulators should continue to evolve regulation to new activities of insurance companies and other financial institutions because it is difficult to predict what "loophole" some firms may capitalize on to get a better yield on their investments.

Funding Agreement-Backed Securities
A representative of the Federal Reserve Board discussed funding agreement-backed securities and their role in the insurance industry. The presence of these securities increases the connection between life insurers and the rest of the financial system because the counterparty to the securities have claims on the funds held by the insurance company, which are not always highly liquid. Although the significance of the FABS market has decreased since 2007, this continues to present a risk to the overall financial system.

Insurance Supervision and Collaboration with the Federal Reserve
The task force heard from the Federal Reserve Board on the shared vision of financial stability and collaboration between the Board and state insurance regulators. The Board views its role as supplementary to the state regulatory system with a focus on risks across the entire entity for significant insurers. Specifically, the Federal Reserve Board continues to focus on ensuring solvency of the insurers under their supervision and being active at the IAIS in developing standards for internationally active insurers. Internationally, the Board believes that consistent global regulatory standards to limit regulatory arbitrage is critical.

CIPR Event

The NAIC's Center for Insurance Policy and Research held a four hour educational session at the Fall National Meeting on the Regulation of Captives. The event was well attended and covered three primary topics with two panel discussions: evolution of captives, regulatory and market development in captives, and remaining challenges and concerns. In his moderator comments, Superintendent Torti of RI stated that the NAIC has identified and made significant progress on all of the major issues related to captives and special purpose vehicles and that the Accreditation process should ensure that all states are regulating companies writing multi-state coverages in a "uniform and consistent manner."

Reinsurance Task Force

The task force met October 26, at the Fall National Meeting and December 9 with the preliminary goal of finalizing *the XXX/AXXX Credit for Reinsurance Model Law* by the end of 2015. However, as a result of the number of comments received and issues identified, the task force realized that goal would not be possible.

Credit for Reinsurance Model Law
The task force continued its lengthy deliberations regarding the scope of commissioner authority with respect to the Model Law. During the Fall National Meeting, as well as an interim conference call on December 9, many options were discussed with

respect to the scope of the Model Law: 1) applicable to only XXX/AXXX captive transactions;
2) XXX/AXXX, variable annuities, and long-term care captive transactions; 3) a broadly-worded scope allowing commissioner discretion, as well as other options that were one of the three options above but with NAIC staff or industry proposed edits.

Industries' most significant concerns regarding the proposed options, voiced both during the Fall National Meeting and the December 9 conference call, related to both the possible unintentional inclusion of P/C products into the Model Law's scope (through option 3), as well as exempting professional reinsurers (intending to limit the scope to captives). Regulators also voiced concerns that proposed Model Law wording that was too vague in terms of scope would have difficulty passing state adoption procedures, while making the scope too limited would require revisiting this Model Law with the introduction of new products or reinsurance relationships in the future.

During its two hour December 9 conference call, the task force voted to pursue "option 2+" with further modifications to address the concerns raised by regulators and industry to narrow the scope wording further, as follows: "(1) life insurance policies with guaranteed non-level gross premiums or guaranteed non-level benefits; (2) universal life insurance policies with provisions resulting in the ability of a policyholder to keep a policy in force over a secondary guarantee period; (3) variable annuities with guaranteed death or living benefits; (4) long-term care policies; or (5) such other life and health insurance and annuity products as to which the NAIC may adopt model regulatory requirements pursuant or related to the NAIC's Credit for Reinsurance Model Law."

On December 15, the revised Model Law was re-exposed for comment until December 31 and a conference call has been scheduled for January 6 to review comments and possibly adopt the Model Law.

XXX/AXXX Credit for Reinsurance Model Regulation

The proposed XXX/AXXX Model Regulation will establish reinsurance requirements for transactions subject to AG 48. During the Summer National Meeting, the task force continued to discuss four options to determine to what extent the credit for reinsurance should be reduced if there is a shortfall relative to the Primary or Other Security collateral, which was exposed through September 30:

1. "All or nothing" – credit for reinsurance only allowed if the entity maintains primary security holdings equal to the principal-based reserve.
2. Dollar for dollar reduction – credit for reinsurance is reduced dollar for dollar by the shortfall between the entity's primary security holdings and the required level per PBR.
3. Percentage reduction – credit for reinsurance is reduced by a proportional percentage of the shortfall between the entity's primary security holdings and the required level per PBR.
4. Primary Security limitation – credit for reinsurance is based on the amount of the entity's primary security holdings.

During an interim conference call on October 26, and in contrast to most of the comments received, the task force elected to draft the Model Regulation with the all-or-nothing option, by a slim 12 to 8 vote. Additional debate is expected in 2016 on this issue. Commissioner Huff noted during the Fall National Meeting that the aim of the task force would be to have the model regulation completed during the first half of 2016.

Update from the Reinsurance Financial Analysis Working Group

The chair reported that during an interim conference call in October, 10 certified reinsurer renewals were approved by ReFAWG, and one certified reinsurer was not recommended for passport status.

Having adopted the Uniform Application Checklist for Certified Reinsurers in December 2014, the working group has met throughout the year to discuss suggested wording changes to address comments received. During the Fall National Meeting, the task force discussed the latest comments made to the Uniform Application Checklist, which was adopted unanimously. Similarly, the Passporting Public Memorandum was adopted as exposed.

Variable Annuity Issues Working Group

The working group was very active this fall, meeting five times in September and October and again in National Harbor, making significant progress on its charges, including adoption of its Variable Annuities-Framework for Change document and disclosures for year-end 2015 financial statements by variable annuity captives.

2015 VA Captive Disclosures

The working group initially recommended expanding the disclosure requirements for variable annuity captives in 2015 to include information on the captive's Plan of Operations, required level of surplus, nature of assets backing assumed liabilities,

required level of hedging, and an RBC-type calculation on a standalone and consolidated basis. Based on comments received and additional discussion, the working group concluded this information would be better captured in a confidential data request. In addition to the data call, new disclosure requirements in the annual and audited financial statements of the ceding company were adopted for 2015 only. (Revised disclosures will be developed for 2016.) The new disclosures include the business purpose of affiliated variable annuity captive reinsurance transactions, reserves held by the captive, reserving methodologies used by captive and how those differ from requirements of AG 43, a tabular presentation of the assets held by or on behalf of the captive reinsurer backing the variable annuity liabilities, and reserve credit taken by the ceding company.

Actuarial Consultants' Report and Quantitative Impact Study

The working group engaged Oliver Wyman to assist in the study of regulatory issues resulting in variable annuity captive reinsurance transactions. Oliver Wyman interviewed 12 VA writers to better understand companies' motivations for variable annuity captive reinsurance transactions. Based on the study, VA insurers use affiliated captive reinsurers for the following reasons: 1) to mitigate non-economic volatility in statutory capital ratios, 2) align market risk profiles of the funding requirements and the insurer target hedge program, 3) mitigate funding requirements in downturn scenarios, 4) consolidate exposure across legal entities, and 5) reduce DTA admissibility limitations of ceding companies.

As a result of the study and follow-up interviews with regulators and insurance companies, Oliver Wyman identified suggestions for improvements:

- Align economically focused hedge assets with liability valuations
- Reform the standard scenario
- Align total asset requirements and reserves
- Revise asset admissibility for derivatives and DTAs
- Standardize capital market assumptions.

The suggested improvements will be reviewed in a quantitative impact study during 2016 to help the regulators better understand the impacts any framework changes would have on the industry. Fourteen variable annuity writers have agreed to participate in the study which is scheduled to being in February and a preliminary report may be available at the Spring National Meeting.

Variable Annuities-Framework for Change

During the fall the working group discussed its draft Framework report to the Financial Condition Committee, which was developed using the input from the Oliver Wyman study. The working group believes the changes proposed by the Framework will 1) encourage strong risk management within the industry and 2) remove the need to reinsure variable annuity business to captive reinsurers. The working group anticipates an effective date of revisions as of 1/1/2017 (which is viewed as an aggressive timeline) and would encourage domestic regulators to recapture their variable annuity business.

Depending on the results of the quantitative impact study, the Framework may result in the following changes:

- Changes to AG 43 to reduce non-economic reserve requirements.

- Changes to the life RBC calculation including material changes to C3 Phase II, such as elimination of the standard scenario.

- Allow hedge accounting treatment under SSAP 86 for certain limited derivative contracts (e.g. interest rate hedges with counterintuitive effects) that otherwise would not meet hedge effectiveness requirements.

- Change to investment statutes in states that may otherwise limit the extent of hedges an insurer can use in risk management.

The working group met via teleconference on October 22 to discuss comment letters and finalize the Framework report to the Financial Condition Committee. During the meeting, the regulators expressed concern about requesting an increase to DTA limitations, but agreed to forward the industry request to the SAP Working Group. Additionally, the working group emphasized that proposed changes to the Framework are not final. The details of the proposed changes cannot be concluded until results of quantitative impact study are analyzed. The Framework report was adopted by Financial Condition Committee on November 5.

The working group also discussed state investment laws. In 2016, the working group plans to develop guidance that represents narrowly defined statutory language that states may use to remove existing

investment limitations that otherwise limit the extent to which an insurer may use hedges in risk management.

Proposed 2016 Disclosures
At the Fall National Meeting, the working group discussed and then exposed for comment a "first draft" proposal until January 29 of potential disclosure changes that would require a new note to the 2016 financial statements for annuities with the objective of "providing all stakeholders (e.g., regulators, consumers, and investors) with more transparency and additional insights into how the contractual obligations could change over time as well as the insurance company's ability to manage those obligations." The proposal includes additional detail on variable and fixed annuity contractual obligations and the impact of changes in factors on variable and fixed annuity liabilities and income of the following: 100 basis point drop and 100 basis point spike in interest rates; 10% drop and 10% spike in lapse rates; increase/decrease in benefit utilization rates by 20% and increase/decrease in volatility assumptions for equities by 20%.

A representative of the ACLI commented that it may require a great deal of work to prepare the proposed disclosures. He also suggested a wide distribution of the proposal since it includes revised disclosures for fixed annuities, which is a different audience than variable annuities.

Blanks Working Group

At its Fall National Meeting, the working group withdrew a previously exposed proposal to add a reinsurance supplement detailing certain information that is aggregated on Schedule F (2015-16BWG), which has now been replaced with a revised Schedule F proposal (2016-26BWG). The new proposal adds a new supplement with details of reinsurers on Schedule F, Part 3 and conforming modification to the existing instructions on Schedule F, Parts 3 and 5. Additionally, the new proposal adds changes to Schedule F Part 3 for asbestos and pollution contracts. A disclosure Note 23J is also being added. The proposal is exposed for comment until February 29.

The SAP Working Group notified the Blanks Working Group of revisions to certain notes to the financial statements that have been adopted by SAPWG for year-end 2015. The following annual statement notes were revised: Note 4–Discontinued Operations, Note 10–Information Concerning Parent, Subsidiaries, and Affiliates, Note 21–Other Items, Note 23–Reinsurance, and Note 31–High Deductibles. With the timing of these SSAP changes, the revised disclosures will be included as narrative "free form" disclosures for the 2015 annual statements. A blanks proposal will be drafted for any needed instructional or data capture changes for the 2016 annual statement.

Investment Reporting Subgroup

During its September and October conference calls, the Investment Reporting Subgroup discussed a new voluntary guidance document developed by the NAIC for reporting the description, issuer, issue and capital structure columns on Schedule D, Part 1 for 2015 annual statements and exposed it for comment; the guidance document was adopted by the Blanks Working Group at the Fall National Meeting. Subsequent to that meeting, however, it was noted that certain interested party comments related to the Description column were not considered by the subgroup; industry believes that the Description column should include information from both the Issuer and Issuer columns and have suggested revisions to the guidance document. The Blanks Working Group re-exposed the guidance document on December 11, and adopted it by e-vote on December 29. The document has been posted to the Blanks Working Group webpage to be used on a voluntary basis for completing 2015 annual statements. The guidance is expected to be included in the 2016 annual statement instructions.

During its October 8th conference call, the subgroup discussed the bond characteristics codes. From staff research, codes 1-4 are used correctly but codes 5-8 are used inconsistently. The subgroup agreed to expose the bond characteristics codes for comment.

Coding related to collateral types was also a focal point of the October meeting. Research shows that some of the codes were not found on the Bloomberg data file and others were found but did not match what was reported by the company. The subgroup discussed whether there were too many codes or not enough guidance on the use of the codes. This discussion topic was exposed to regulators and interested parties for comment.

During the fall, the Investment Reporting Subgroup developed an Investment Reporting Survey relating to the description field for Schedule D. The survey asks insurance departments to choose their preference for this field: Option 1 is to include issuer only (as included in the annual statement instructions for the electronic only column); Option 2 is to keep the current description requirements but add clarifying instruction and additional bond characteristics codes, and Option 3 is to add

additional descriptions and related instructions. Results to the survey will be discussed in 2016.

Governance Review Task Force

The task force held in National Harbor its first public meeting since the spring. The National Association of Corporate Directors (NACD), which had been appointed consultant in early 2015, delivered its report to the NAIC in June. Recommendations included in NACD's report were aggregated into 4 areas:

- NAIC bylaws and role of Officers, Executive Committee and Senior Management
- Transparency in communications and process
- Committee leadership, structure and inclusion
- Commissioner on-boarding and continuing education.

The task force noted that certain recommendations related to the last item are already in process of being implemented.

The task force then walked through proposed changes to the NAIC bylaws in response to the recommendations, summarized into a) process improvements, including specifically requiring monthly Executive Committee meetings;
b) expanded member participation in parent committees, increasing membership from 13 to 15 and extending committee appointments until completion of subsequent committee selection processes in January rather than expiring at year end; and c) streamlined voting at Executive Committee, specifically limiting voting to the most recent past president, rather than all past presidents.

The proposed streamlined voting structure would reduce the voting to 17 members: 4 NAIC officers, 12 zone officers and 1 past president. Currently there are 20 members voting, based on inclusion of all past presidents. Commissioner Sevigny (NH) was vocal in his concern that the limitation of voting at Executive Committee to the most recent past president was "finding a solution where there wasn't a problem," and asked that each proposed change to the NAIC bylaws be voted on separately. Changes to the NAIC bylaws require a supermajority, and each proposed change was adopted unanimously, other than this Executive Committee voting limitation, which was voted against by Commissioners Sevigny and Donegan (VT). Even with these two opposing votes, a supermajority was achieved, and all proposed amendments were adopted by the task force. These amendments were also adopted by Executive Committee and Plenary during their December 17 conference call.

Life Insurance and Annuities Committee

The committee met via conference call on October 28 and in National Harbor and discussed the following topics.

Proposed Revision to DOL Definition of Fiduciary
At the Fall National Meeting, the committee heard a report from NAIC staff on the U.S. Department of Labor's proposed regulation to broaden the definition of "fiduciary" under the federal Employee Retirement Income Security Act and the Internal Revenue Code. The proposed rule is comprehensive and complex, and would greatly expand the definition of who is considered an ERISA fiduciary to include many insurance agents, insurance brokers and insurance companies.

NAIC staff have continued to meet with DOL officials to obtain additional clarity on how they will implement the new standards within the rule. The U.S. Congress has also been engaged in examining the proposed rule through oversight hearings and proposing legislative alternatives. One alternative being considered in the House is transferring authority from the DOL to the Treasury for this rule. There has been no set date when the proposed rule will become final; however, proponents are pushing to get the amendment passed before the President leaves office. The Congressional budget adopted December 18 ultimately did not include riders that would have changed the process of the DOL's proposal.

Life Illustrations
Based on comments received on the issues and concerns with the *Life Insurance Illustrations Model Regulation* (#582), the committee established a new working group to explore how the narrative summary of Standards for Basic Illustrations required by Section 7B of Model #582 and the policy summary under the *Life Insurance Disclosure Model Regulation* (#580) can be enhanced to promote consumer readability. The working group is to present any recommended enhancements by the 2016 Summer National Meeting.

Life Insurance Policy Locator Service
After hearing a presentation from the Oklahoma Department of Insurance during the Summer National Meeting, the NAIC decided to explore the feasibility of the NAIC developing a life policy locator

service. Many states already have such a service and the NAIC has a life insurance company location system available to users on the website. During the Fall National Meeting, the states discussed what is currently available and how the NAIC could centralize the information. While the NAIC already has a tool available, it is not being monitored for updates in name changes, sold blocks, merged insurance companies, etc. Additional considerations for centralization include technology limitations and security risks with confidential or personally identifiable information. The committee requested that staff survey NAIC members to determine the number of states that would be interested in the NAIC centralizing this service and also exploring possible solutions to ensure best practices are considered in the implementation.

Life Actuarial Task Force

During the day and a half dedicated to the LATF meeting, the majority of the discussions related to Valuation Manual amendments, including adoption of some proposals and exposure of others. This topic and other highlights from the Fall National Meeting are summarized below.

Indexed UL Illustration Guidance
Actuarial Guideline 49, *The Application of the Life Illustrations Model Regulation to Policies with Index-Based Interest*, was adopted by LATF in April following the Spring National Meeting, and subsequently by both the Life Insurance and Annuities Committee and the Executive Committee and Plenary in June. For purposes of expediency, the adopted guideline excludes some clarifications that were discussed during the drafting of the guideline but for which timely consensus or resolution could not be reached. LATF then established the IUL Illustration Subgroup to consider post-adoption enhancements to AG 49.

At the Summer National Meeting and during the interim period the subgroup discussed revisions to the guideline to address policies with dual accounts. The issue is that for these policies, each having its own set of charges, the guideline as written allows different rates to be illustrated based on whether charges are implicit or explicit, when in reality the illustrated rates should be the same. During the interim period the IUL Illustration Subgroup exposed revisions to AG 49 to address this issue. The comment period ended on November 30 and at the Fall National Meeting the subgroup continued discussion of the issue and comments received at that time. Support for the proposed changes is not overwhelming since some regulators believe the changes only address part of the problem, but regulators and interested parties seemed to agree that the complexity in these products suggests a need for broader changes in the model illustration regulation itself and the required disclosures.

The subgroup also discussed the issue of how policy bonuses should be reflected in IUL illustrations, but noted that this issue is not unique to IUL. These topics and others will be discussed on future conference calls.

PBR Valuation Manual and Related Matters
<u>Mortality-Related Valuation Manual Proposals</u>
During the interim period LATF discussed and adopted VM amendments regarding the PBR mortality margins and the previously exposed Underwriting Criteria Score Calculator. Changes to the PBR margins were to (1) allow the choice between Buhlmann and Limited Fluctuation credibility methodologies, but the chosen method must be applied to all business subject to VM-20, (2) require commissioner approval to change from one methodology to the other as well as a demonstration of the rationale for the change, (3) reduce credibility ranges to 5% intervals to help smooth the results, and (4) determine credibility by death claim amount instead of claim count. In National Harbor, the task force adopted the 2017 CSO valuation table and also adopted the clarification that allows companies which elect the three-year PBR transition to VM-20 to elect the 2017 CSO table as the valuation mortality standard during that period, as discussed in the "Valuation Mortality Tables" section below.

Other amendment proposals were exposed for comment periods ending January 8 or January 15. Most proposals were clarifying/clean-up items, and included the following: (1) a clarification on the definition of substantial secondary guarantee as one that keeps a policy in force for more than 5 years, and (2) modifications to the deterministic reserve exclusion test including that annual lapse rates are 0% and an additional requirement that the shock lapse rate is 100% at the end of the level premium period. An additional proposed change clarifies that if the net premium produced by the company's mortality is higher than the net premium produced by using the CSO mortality, then the company anticipated mortality should be used.

<u>Other Valuation Manual Amendments</u>
During the interim period, LATF exposed and adopted the Academy proposal for the treatment of

yearly renewable term reinsurance in the Stochastic Exclusion Test (SERT). When reinsurance is non-proportional, the SERT ratio can be dramatically different pre and post reinsurance, and the adopted amendment includes a provision for companies to demonstrate that the sensitivity of the deterministic reserve to economic scenarios is comparable pre and post reinsurance, thereby allowing the SERT to "pass" in the presence of YRT reinsurance.

<u>VM-20 Spread Tables</u>
Under the VM-20 framework, investment spreads and default costs are provided based on source data from vendors J.P. Morgan Chase and Bank of America; default costs will be updated annually while investment spread costs will be updated quarterly. During the interim period LATF exposed and adopted the September 30 spread tables and also exposed the default costs updated with Moody's data through December 31, 2014. During the Fall National Meeting the task force adopted the updated default costs. Because PBR is not yet effective, the VM-20 spread tables currently apply only to testing under Actuarial Guideline 38.

Academy Council on Professionalism
The task force received an update from a representative of American Academy of Actuaries Council on Professionalism and activities within the Actuarial Standards Board and the Actuarial Board for Counseling and Discipline. Actuarial Standard of Practice 21 *Responding to or Assisting Auditors or Examiners in Connection with Financial Audits, Financial Reviews, and Financial Examinations* was exposed for comment through the end of the year. This ASOP was last updated in 2004, and the current draft reflects changes to address the actuary's responsibility with respect to process and controls in the Sarbanes-Oxley environment and under the Model Audit Rule, and the risk-based focus of financial audits and examinations. Related to this, the ABCD representative noted questions had been received from both regulators and companies with regard to responsibilities relative to financial examinations, and that the exposure draft addresses these questions received. The representative also noted an increasing number of questions regarding practicing actuaries' qualifications to do the work they are doing.

Work continues on the Modeling Actuarial Standard of Practice and a draft is expected to go back to the ASB in March. The ASB is also looking into developing a new standard specific to assumption setting.

During this session the Academy's immediate past president provided an update on the regulator testing of the attestation form that will allow actuaries submitting statements of actuarial opinion to document their qualifications under the U.S. Qualification Standards. Feedback has been on technical issues and also content. The Academy expects a working version of the form to be available for attestation for year-end 2015 work.

Actuarial Guideline XXXIII (AG 33)
During the interim period LATF adopted proposed changes to AG 33 that had been exposed at the Summer National Meeting. These changes were subsequently adopted by the Life Insurance and Annuities Committee in October and the Executive Committee and Plenary at this meeting and hence are effective for year-end 2015. The changes clarify considerations regarding elective and non-elective integrated benefit streams and the application of incidence rates to those benefit streams.

VM-22 Fixed Annuity PBR
LATF received a report from the VM-22 Subgroup on work related to development of PBR methodology for non-variable annuities. During the interim period the subgroup discussed a proposal for a simplified valuation of guaranteed living income benefits and other optional benefits on non-variable annuity contracts. Key elements of the proposed method are that all optional benefits are valued (i.e. no benefit is unvalued), valuation interest rates are based on current rates, and a policyholder efficiency (i.e. optimal utilization) assumption of less than 100%. The subgroup also received and discussed the Academy Annuity Reserve Working Group's draft sections of VM-22 addressing minimum reserve methodology and floor reserve requirements. The Academy Work Group cannot make further headway on the draft until the model reserve framework is determined.

The subgroup also received a report from the Academy SVL Modernization Working Group focused on evaluating the SVL interest rate methodology for non-variable annuities, particularly single premium immediate annuities and structured settlements. The working group recommends use of daily interest rates to address non-uniformity issues such as those that arise in the jumbo pension risk transfer market from variability in the timing of single group annuity premiums during the year, and quarterly interest rate calculations aligned with VM-20 (i.e. based on Treasuries with adjustments for spreads and margins) for other annuity business. The recommended approach also eliminates a floor

on the valuation interest rates, noting that insurers would likely have an economic cost in such environments since they generally do not hold large amounts of cash. Discussion of VM-22 matters will continue on future conference calls.

Valuation Mortality Tables

During the interim period, LATF discussed the 2017 CSO Mortality report with members of the Academy and Society of Actuaries Joint Project Oversight Group, but decided to allow more time to review the report before a motion is considered. With additional time to review the report, the 2017 Commissioners Standard Ordinary mortality table was adopted in National Harbor for use in both determination of non-forfeiture values and reserve valuation for issues on or after 2020 with the option to use the table during the three year transition period following adoption of PBR. The transition period is expected to be January 1, 2017-December 31, 2019.

In National Harbor, LATF also received an update from the Joint Academy Life Experience Committee and Society of Actuaries Preferred Mortality Oversight Group on the development of Guaranteed Issue, Simplified Issue and Pre-need mortality tables. The report was brief due to time constraints but a key observation of the Joint Project Oversight Group is that the PBR margins were not created for simplified/ guaranteed issue and will need to be revised for application to these risk classes. No action was taken at this meeting and the discussion of the matter will continue on future conference calls.

Contingent Deferred Annuity Subgroup

The CDA Subgroup reported on activity during the interim period to review prescribed assumptions in Actuarial Guideline 43 for appropriateness relative to CDAs, as well as the need for changes to the financial reporting blanks to address financial reporting requirements for CDAs. With regard to prescribed assumptions, the subgroup focused on lapse and benefit utilization experience on variable annuities with guaranteed living benefits and considered experience data provided by LIMRA. The subgroup concluded that based on current information, CDA experience appears similar enough to variable annuity experience that there is no basis for prescribing different assumptions for CDAs than those in AG 43. The subgroup also concluded that the current Exhibit 5 Interrogatory item 8 provides sufficient information regarding CDA exposure and as such, no changes to the annual statement are required at this time. These recommendations were adopted and forwarded to the CDA Working Group. The subgroup chair noted that subgroup members hope to complete their charges in the near future and disband.

Nonforfeiture Modernization

LATF devoted an hour and a half to hear and discuss an update from the Academy Nonforfeiture Modernization Work Group. The update covered highlights of the proposed Gross Premium Nonforfeiture Method (GPNM) and application of the method to selected products including Level Premium Term, Universal Life with and without secondary guarantees, Traditional Whole Life, Fixed Deferred Annuities and Annuities with Guaranteed Living Benefits. Under the GPNM framework nonforfeiture benefits would reflect the funded portion of the risks assumed by the company under the policy, using a retrospective approach based on guaranteed assumptions supported by the gross premiums. The most lively and humorous moments emanated from one regulator questioning regulator commitment to non-forfeiture modernization, noting the recent celebration of the 25th anniversary of the former chair of the work group. Once the laughter subsided, more serious discussion continued on how to focus this work. No decisions were made but discussion will continue on a future conference call.

Generally Recognized Expense Table

During the interim period LATF voted to adopt the 2016 GRET factors developed by the SOA Committee on Life Insurance Company Expenses, which were exposed at the Summer National Meeting. The 2016 GRET factors were adopted by the Executive Committee and Plenary at Fall National Meeting so they are now final.

Emerging Actuarial Issues Working Group

The working group was formed by the NAIC to address implementation issues resulting from the revisions to AG 38 for universal life products with secondary guarantees. To date the working group has adopted 42 interpretations including a revision to INT 39 adopted during the recent interim period.

The revised INT 39 impacts valuations as of December 31, 2016 and later and provides that, for purposes of comparing actual and hypothetical portfolio yields to determine the appropriate portfolio to use in development of the deterministic reserve, the actual portfolio net investment return be

adjusted by the current amortization of IMR allocated to the portfolio. This adjustment is consistent with the determination of reserves under VM-20.

Submitted questions, exposed responses and adopted interpretations are available on the working group's webpage.

PBR Review Working Group

The working group met in National Harbor and received updates from its subgroups.

PBR Blanks Reporting Subgroup
The subgroup met via conference call October 23 with NAIC and ACLI staff to review the ACLI's comments on the second draft of proposed revisions to the Blanks and instructions pertaining to VM-20 (i.e. the VM-20 Supplement). At the Fall National Meeting, the PBR Review Working Group exposed the package for a third comment period ending December 18. The VM-20 Supplement is two parts: Part 1 is Life Insurance Reserves by Product Type, and Part 2 is Three Year Transition Period and Small Company Exemption. The rest of the exposure document is instructional changes to incorporate PBR on existing annual statement schedules, e.g. Analysis of Increase in Reserves and Exhibit 5, Aggregate Reserves for Life Contracts. The chair noted that there is a "good chance" the PBR blanks project will be done by the time the PBR Pilot Project begins in 2016. See further discussion of the pilot project below.

2016 PBR Pilot Project
The working group reviewed the 2016 PBR Pilot Program Outline document in National Harbor; the working group is overseeing the pilot and is looking for up to ten companies (and their domiciliary states), which are planning to value business under VM-20 once the operative date is triggered. Each volunteer will decide which product or products to be tested and will complete the VM-20 Reserve Supplement and the VM-31 Actuarial Report requirements. The goal of the PBR Pilot Project is to "test out and evaluate the PBR regulatory processes as defined in the Standard Valuation Law and Valuation Manual to determine if any changes need to be made to the regulatory processes, requirements defined in the Valuation Manual and reporting requirements as defined in the VM-20 Supplement to the annual statement blanks and the VM-31 reporting requirements." The pilot will also focus on PBR calculations (NPR, DR and SR) for term and ULSG products as required by VM-20.

The working group hopes to finalize volunteers by the end of December and begin testing March-June 2016 with a final report to the PBR Implementation Task Force in December 2016. The chair encouraged companies to volunteer as the project will be an excellent "training in the trenches" for life insurers who will be required to adopt PBR very soon in any event.

NAIC Support for PBR
The working group heard an update on NAIC actuarial staff and modeling software selection. The NAIC hired two actuaries in 2014 and plans to hire two more in 2016 to support the states in analysis and examination of PBR valuations. The NAIC actuaries will also work with the Valuation Analysis Working Group to help ensure the states consistently apply the PBR requirements. NAIC staff also noted they are continuing to evaluate modeling software and hope to have a decision shortly.

PBR Review Procedures Subgroup
The subgroup held conference calls October 27 and November 3 to continue discussion of draft revisions to the Financial Analysis Handbook to incorporate principle-based valuation guidance developed by NAIC staff. The proposed revisions were exposed by the PBR Review Working Group for a comment period ending December 18 and suggest revisions to guidance on Level 2 Life Reserves. The subgroup will now begin discussing potential revisions to the Financial Condition Examiners Handbook to address PBR examination issues.

Health Actuarial Task Force

Long-Term Care
At the Fall National Meeting the LTC Actuarial Working Group continued discussion of the results of a joint SOA/LIMRA LTC policy termination experience study, for which results were first presented at the Summer National Meeting. The LTC Valuation Subgroup held two conference calls during the interim period to discuss this study and clarify understanding of the experience trends. SOA/LIMRA representatives who prepared the study presented at each discussion. The study is based on experience during 2000-2011 and includes data from 22 carriers representing 75% of in-force lives. Voluntary lapse rates and mortality rates were reported for a variety of experience categories. The results of this study are available on the SOA website.

The LTC Actuarial Working Group received an update from the Academy Long-Term Care Principle -Based Work Group on the report regarding a

principles-based approach for establishing health insurance reserves and LTC in particular, including a prototype stochastic valuation model. The report is in the final stages of review within the Academy and will be delivered and presented to the LTC Working Group by year-end.

The LTC Actuarial Work Group received an update from the Academy Long-Term Care Credibility Monograph Work Group on its draft monograph. The draft is under review within the Academy and will be released next year.

The LTC Actuarial Working Group also heard a presentation from Fred Andersen (MN) on a draft framework for a "Collaborative LTC Rate Increase Review Method." The framework is intended to make the review of LTC rate increase requests more transparent and uniform among states. Under this approach, a specific formula will be used to determine the level of rate increase. An inventory of required documentation and other supporting information would also be required as part of the rate filing. State laws and regulations may need to be changed in order to achieve uniformity among the states. Mr. Andersen requested that regulators provide feedback on the draft documents. No additional action was taken at this meeting.

<u>Individual Disability</u>
The Health Actuarial Task Force heard an update from the Academy Individual Disability Table Work Group regarding the modified 2013 Individual Disability Income Valuation Table, instructions and report exposed in April 2015. Comments received during the exposure period expressed concern that the incidence modifiers for employer-sponsored business did not differentiate by underwriting type. During the interim period, the Individual Disability Valuation Table Implementation Subgroup considered this matter and in National Harbor presented to HATF members a supplemental study of employer-sponsored claim incidence that is the basis for revised incidence modifiers. The modified table was subsequently adopted on a December 11 task force conference call.

Contingent Deferred Annuity Working Group

The CDA Working Group discussed comments received on its draft document "Guidance for the Financial Solvency and Market Conduct Regulation of Insurers Who Offer Contingent Deferred Annuities." The working group developed this guidance to serve as a reference for states that are either interested in modifying their annuity laws to clarify their applicability to CDAs or to help states determine how to apply their existing annuity laws and rules to CDAs. The working group agreed to make revisions to the guidance document based on the comments received and adopted the revised document in National Harbor. The document was also adopted by Executive Committee and Plenary during their December 17 conference call.

The adopted document does not include guidance on cancellation benefits that had been previously discussed by the working group. Because that issue will need additional discussion, the working group elected to adopt the current document to allow states to use it immediately.

Financial Regulation Standards and Accreditation Committee

<u>Definition of Multi-State Insurer</u>
The committee received an update on the internal process that will be used in 2016 to monitor compliance with the new Part A Preamble guidance that was adopted during the Summer National meeting relating to certain captives and special purpose vehicles. This process includes developing an inventory of all captive reinsurers that assume XXX/AXXX business by collecting the Supplemental XXX/AXXX Reinsurance Exhibit, Part 2B for all non-grandfathered captive reinsurers. To ensure the list is complete and accurate, NAIC staff will also contact the domestic state of ceding insurers to make sure that all cessions are included on the list. Once the listing is complete, the NAIC staff will review the information to determine if there are Primary or Other Security shortfalls, and where they exist, the NAIC will take additional action to determine if the shortfalls have been remediated and other requirements in the XXX/AXXX Reinsurance Framework have been met.

NAIC staff discussed two additional areas where revisions need to be considered for the definition of multi-state insurer: 1) description of risk retention group multi-state business; and 2) revisions to Part B to be consistent with Part A.

1) RRG multi-state business – Under the revision, there are several criteria and if any are met, the RRG would be considered a multi-state insurer. The proposed criteria include operating or being licensed or registered in more than state, or being an accredited or certified reinsurer in more than one state.

2) Part B Preamble – The proposed revisions update the description of what constitutes a multi-state insurer (particularly relating to reinsurance assumption) to be in line with what was adopted in Part A. The update does not, however, include the suggested inclusion of captive reinsurers that is included in Part A. NAIC staff plan to continue discussions related to the inclusion of captive reinsurers in Part B during 2016.

Both of the proposed revisions above were exposed until December 9.

Certified Reinsurer
The committee discussed the optionality of states to adopt the certified reinsurer provisions as part of the Credit for Reinsurance Model language necessary for accreditation. The NAIC discussed making the certified reinsurer provision a requirement. Several interested parties weighed in; it was unanimous that uniformity across the states is needed. The committee directed NAIC staff to draft specific revisions to incorporate the certified reinsurer provision into the accreditation guidance.

ORSA Model Act
During the Fall National Meeting, the committee further discussed certain significant elements of the *Risk Management and ORSA Model Act* that will become an accreditation standard effective January 1, 2018. Based on discussion, one minor change in language was made to the confidentiality section. There was no further discussion on the "substantially similar" criteria.

Review Team Guidelines
The committee adopted revisions to the Review Team Guidelines that allows for individuals who do not hold the Certified Financial Examiner credential to act as examiners-in-charge (EIC) of financial examinations. The revisions are effective as of January 1, 2016 and stipulate that the qualifications of the EIC, including why they are able to act in this capacity, need to be documented within the NAIC Financial Examination Electronic Tracking System.

Risk Limiting Contracts Working Group

The working group has not met since July 30 but a new chair was recently identified to replace the former chair from Illinois; the working group is expected to hold a conference call in early 2016.

Casualty Actuarial and Statistical Task Force

Since the Summer National Meeting, the task force met by conference call on September 29, October 13, and October 27, and met in National Harbor to discuss the following matters.

Price Optimization
At the Summer National Meeting, the task force exposed its revised white paper and recommendations on price optimization. During each of conference calls, the task force heard comments from industry and interested parties and exposed a revised version of the document that incorporated comments from the previous version. Seven organizations submitted comment letters with several submitting multiple letters. In National Harbor, the task force adopted its white paper and recommendations. The adopted white paper provides background research on price optimization, identifies potential benefits and drawbacks to the use of price optimization, and presents options for state regulatory responses regarding the use of price optimization in ratemaking.

The task force stated that it is not expressing an opinion on the policy decisions that have been or may be made by each state concerning rating practices that may incorporate price optimization. The task force also stated that it recognizes there are numerous definitions of price optimization as companies may use the term to encompass activities that include retention models, elasticity of demand, maximization of profit, competitive analysis, etc. As such, the task force agreed not to recommend a definition of price optimization but rather, under any definition of price optimization, recommend that the states address the requirement in their state rating laws that "rates shall not be excessive, inadequate, or unfairly discriminatory."

The task force recommends that insurance rating practices that adjust the current or actuarially indicated rates or the premiums, whether included or not included in the insurer's rating plan, should not be allowed when the practice cannot be shown to be cost-based or comply with the state's rating law. The white paper includes a list of practices deemed to be unfairly discriminatory, such as price elasticity of demand, policyholder's propensity to shop for insurance, retention adjustment at an individual level, and a policyholder's propensity to ask questions or file complaints. The white paper also includes three considerations for states, which are:

1) consider issuing a bulletin to address insurers' use of methods that may result in non-cost based rates,

2) consider enhancing requirements for personal lines rate filings to improve disclosure and transparency around rates, rate indications and rate selections, and

3) analyze models used by insurers in ratemaking to ensure the model adheres to state law and actuarial principles.

2015 Regulatory Guidance
The task force adopted the "Regulatory Guidance on Property and Casualty Statutory Statements of Actuarial Opinion for the Year 2015" and the "Regulatory Guidance on the Property and Casualty Actuarial Opinion Summary for the Year 2015" via an e-vote. The regulatory guidance documents were sent to AAA's Committee on Property and Liability Financial Reporting for inclusion as an appendix in its annual practice note.

Risk-Focused Surveillance Working Group

The working group met by conference call in October and at the Fall National Meeting to discuss the following topics.

Group Profile Summary
The working group addressed comments received on the updated Group Profile Summary template and related revisions to holding company analysis guidance. As discussed in previous meetings, the Group Profile Summary is proposed to be the primary deliverable of holding company analysis and the means for sharing the results of the holding company analysis across states. Revisions discussed include allowing states to exercise discretion regarding which parts of the GPS would be required for different insurers and requiring lead states to verify the ability of other regulators to keep the GPS confidential. The working group referred the GPS template and related revisions to the holding company analysis guidance to the Financial Analysis Handbook Working Group for consideration of adoption. On November 4, the Financial Analysis Handbook Working Group held an e-vote and adopted the handbook revisions after adding clarifying language on confidentiality related to the GPS pursuant to comments received in an industry comment letter.

Financial Analysis Processes
The working group continues to consider revisions to modernize the financial analysis process. The working group is focused on modifying the goals to incorporate consideration of other relevant industry-wide initiatives such as holding company analysis, ORSA, and branded risk classification.

Climate Change and Global Warming Working Group

In National Harbor, the working group heard presentations which reflect an increased global focus on climate change.

U.N. Climate Change Conference
The Fall National Meeting preceded the United Nations Climate Change Conference held November 30-December 11 in Paris; the working group heard a preview of the conference in National Harbor from Ceres, the non-profit sustainability advocate.

Many countries have consented to publicly outline what post-2020 climate actions they intend to take as part of the new global deal, known as their intended nationally determined contributions (INDCs). China has agreed to peak its carbon dioxide emissions and reduce the carbon intensity of its economy. The U.S. intends to achieve an economy-wide target of reducing its greenhouse gas emissions by 26% to 28% below its 2005 level by 2025. More than 90% of the world's emissions are covered by 158 countries that have submitted an INDC. The United Nations Environment Programme published its annual Emissions Gap Report noting that without enhanced ambition, the likely global average temperature increase could reach 3.5 degrees Celsius by the end of the century. By the end of 2015, global temperatures are set to reach 1 degree Celsius above pre-industrial levels for the first time, a sobering halfway point to the warming limit of 2 degrees Celsius that many scientists say cannot be surpassed if the worst effects of climate change are to be avoided. The gap however can be bridged by: 1) greater energy efficiency, with a focus on industry, buildings and transport; 2) expanded use of renewable energy technologies; 3) initiatives at city and regional levels that can be rapidly accelerated; and 4) expansion of forest mitigation actions.

After the Fall National Meeting and after lengthy debates in Paris, delegates at the U.N. Climate Change Conference adopted a climate-change pact on December 12. The agreement is the world's first comprehensive climate agreement with all countries expected to participate. The agreement includes a commitment to keep the rise in global temperatures "well below" 2 degrees Celsius compared to pre-industrial times while striving to limit them even more to a 1.5 degrees Celsius increase. The agreement also calls on developed

nations to contribute $100 billion annually to help developing countries combat climate change and foster greener economies by 2020. The agreement also sets the goal of a carbon-neutral world sometime after 2050 but before 2100. Countries will be tasked with preparing, maintaining and publishing their own greenhouse gas reduction targets.

Impact of Climate Change on UK Insurance Sector
This Bank of England September 2015 report provides a framework for considering the financial risks arising from climate change and takes the form of an initial risk assessment to inform the Prudential Regulation Authority's future work and contribute to the international dialogue. The report identified three main channels through which climate change may impact the insurance sector: 1) direct and indirect physical risks from weather-related events; 2) transition risks from the transition to a lower-carbon economy; and 3) liability risks from parties who have suffered loss and damage from climate change.

FSB Proposed Disclosure Task Force
In November 2015, the Financial Stability Board issued a proposal for a disclosure task force on climate-related risks. The task force would be an industry-led effort to develop voluntary, consistent climate-related disclosures. A specific focus will be on the needs of market participants for information regarding physical, liability and transition risks from climate change, including investors, lenders and insurers (specifically with respect to underwriting information). Using climate-related disclosures, stakeholders could assess the credibility of the companies' transition plans, and analyze the changes in assets and liabilities that could result from a transition to a lower carbon economy.

The Organisation for Economic Cooperation and Development
A special session was held in Paris on December 3 that focused on issues for insurance regulators as a result of a changing climate and the efforts that regulators have made to address these issues.

The working group chair noted that his key concern was the impact to balance sheets from a rapid policy change which could affect affordability and availability of insurance. The working group discussed that significant leadership at the local, state and federal level is needed from policymakers to achieve goals such as stronger building codes and better land-use policies. A working group member commented that the NAIC, together with the state insurance departments, should be driving the message on this, because insurers will not want to cover risks where they know they will have significant losses. The federal government also needs to look at how it incentivizes or disincentivizes the states to review building codes and land-use practices through post-disaster aid assistance programs. The chair stated his support for the working group to look into better building codes and land-use practices. No action was taken by the working group on this matter.

Mortgage Guaranty Insurance Working Group

The working group met at National Harbor to discuss its projects.

Model Act and Standards Manual
The working group discussed revisions to the fifth version of the extensively revised draft Mortgage Guaranty Insurance Model Act. The working group discussed a joint California and Wisconsin proposal related to reinsurance. The proposed changes would address provisions within the federal Dodd-Frank Wall Street Reform and Consumer Protection Act and the *Credit for Reinsurance Model Law* (#785). The proposal allows a domestic ceding mortgage guaranty insurer to receive a credit for reinsurance as either an asset or deduction from liability in cases where cumulative reserves established by the mortgage guaranty insurer and the reinsurer are not less than 100% of the reserves as required by the act, and the cession is accounted for as retroactive insurance in accordance with SSAP 62R (to allow surplus gains to be earned throughout the period of the risk). The proposed revisions also require that if the reinsurer does not maintain a contingency reserve, it would need to establish 100% collateral. The working group asked for feedback on the proposed revised reinsurance requirements.

Significant changes are also being proposed to several subsections of Section 7, Capital Standards. One relates to business writing authority requirements whereby the trigger to cease writing new business was revised to reflect a more conservative capital solvency calculation under a stress scenario. Revisions were also made to Section 7 (A) (4) (b) dividend restriction guidance to not allow contingency reserve releases to be used to pay dividends. Industry representatives raised a concern that this change may be excessively restrictive since provisions already exist to require domiciliary approval and to prevent payment of "imprudent dividends." The Private Mortgage Guaranty Insurance Industry Group provided a one page memo summarizing industry comments dated November 20, and plans to submit additional detailed comments in writing.

The working group also heard an update on the progress of the second version of the previously exposed Mortgage Guaranty Insurance Standards Manual, which will be referenced in the model act. Revisions to the manual are consistent with those made to the draft act. The working group will continue discussing the draft model law and the standards manual which have a comment deadline of April 6.

Capital Model
The working group heard updates from several states noting that actuaries from Arizona, California, New York, North Carolina and Wisconsin are reviewing the capital model. The working group discussed public exposure of the model in 2016 to encourage review by industry and interested parties.

Timeline to Completion
The working group will consider in January whether an extension past spring 2016 will be necessary to complete its three projects.

Terrorism Insurance Implementation Working Group

The working group heard reports from recent Federal Insurance Office meetings related to collecting terrorism data. The FIO reiterated its message from the Summer National Meeting that they will begin collecting in 2016 data referenced in *Terrorism Risk Insurance Program Reauthorization Act of 2015* (TRIPRA 2015). The FIO continues to welcome input from state insurance regulators, with a goal of avoiding a duplication of data-collection efforts. NAIC staff also reported that they reached out to the FIO with its plan to collect terrorism data directly from U.S. insurers. The NAIC offered to share any data elements collected by state regulators with the Treasury to reduce duplication and cost on the industry.

The working group discussed the status of a data call that 11 states plan to issue. The data call, led by New York, would collect data at a ZIP-code level, and is meant to meet the needs of state insurance regulators, while also collecting data specified in TRIPRA to share with the FIO. The states are seeking feedback on the timing of the data call, additional information on available data elements, clarification of instructions and how to avoid duplication of data requests. Feedback was also requested during the Fall National Meeting. Interested parties, such as the PCI and Center for Economic Justice, urged the states to align their efforts with the FIO before finalizing the data call. Additionally, they suggested that state regulators and the FIO should consider what insurers are already reporting, or at least what is available with current systems.

The items above were also summarized during the Blanks Working Group meeting, specifically related to adding instructions and collection of terrorism data for the annual 2016 filing. A proposal will need to be submitted no later than the Spring National Meeting to be included in the annual 2016 statement.

Sharing Economy Working Group

At National Harbor, the Sharing Economy Working Group discussed the following topics.

Update on States with Enacted TNC Legislation
The working group received an update from NAIC staff regarding states with enacted transportation network companies (TNC) legislation. Twenty-seven states and the District of Columbia have passed TNC legislation to date, a significant progress compared to a year ago when only California and Colorado had signed legislation. All states are using a phased approach in their legislation, identifying time periods for which the limits and coverages apply. For instance, most states require lower liability limits and fewer coverage types during the time a TNC driver is logged into the TNC's digital network and is available to receive transportation requests but has not yet accepted a ride request (commonly referred to as "Period 1"). Eighteen of the twenty-eight states and jurisdictions with TNC legislation used the minimum liability limits described in the TNC Insurance Compromise Model Bill which was developed by the TNCs in coordination with a few insurance companies and industry associations.

A vast majority of the states require a $1 million minimum liability limit for the time period when the driver is actively engaged in TNC services. Most states include a provision requiring the insurers and TNC to work together in claims investigations. The most common disclosures required by law include: 1) the TNC must inform the driver of the coverage provided by the TNC, as well as the fact that the driver's personal auto insurer may exclude coverage for TNC services subject to the terms of their policy; and 2) TNC drivers must carry proof of insurance in the vehicle while it is being used for TNC services. Following the update, the chair requested for NAIC staff to perform a similar study of legislation on an annual basis.

Insurance Products Designed for TNCs

The working group heard a presentation from an insurer on TNC products noting that one product offered ensures drivers are properly covered throughout all phases of the TNC service. The product provides coverage in excess of the liability limits by the TNC with drop-down coverage for deductibles to match the selections chosen by the driver in his or her own auto policy. Because the physical damage deductibles required under the TNC coverage are often much higher than those typically selected by the insureds in their personal auto policy, the drop-down coverage is necessary to decrease the deductible amount. Following the presentation, a working group member inquired whether the insurer has received any feedback about the cost being prohibitive and counteracting the benefits received from driving for the TBC; the insurer informed that no negative feedback has been received.

Coordination of Coverage

The working group heard a presentation from Uber on coordination of coverage noting that twenty-two insurers have filed TNC products in twelve states. A majority of the policies are designed to be primary coverage for Period 1 in the TNC framework. Uber employs full-time claim advocates dedicated to coordinating claims investigations with carriers and customers, and no known coverage disputes exist at this time.

Following the presentations, the working group stated that it will continue to monitor TNC legislation as it develops. The chair suggested that the working group and NAIC staff review consumer alerts developed by the states and provide feedback.

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The next National Meeting of the NAIC will be held in New Orleans April 3-6. We welcome your comments regarding issues raised in this newsletter. Please provide your comments or email address changes to your PricewaterhouseCoopers LLP engagement team, or directly to the NAIC Meeting Notes editor at jean.connolly@pwc.com.

Disclaimer

Since a variety of viewpoints and issues are discussed at task force and committee meetings taking place at the NAIC meetings, and because not all task forces and committees provide copies of agenda material to industry observers at the meetings, it is often difficult to characterize all of the conclusions reached. The items included in this Newsletter may differ from the formal task force or committee meeting minutes.

In addition, the NAIC operates through a hierarchy of subcommittees, task forces and committees. Decisions of a task force may be modified or overturned at a later meeting of the appropriate higher-level committee. Although we make every effort to accurately report the results of meetings we observe and to follow issues through to their conclusion at senior committee level, no assurance can be given that the items reported on in this Newsletter represent the ultimate decisions of the NAIC. Final actions of the NAIC are taken only by the entire membership of the NAIC meeting in Plenary session.

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AUTHORS WANTED

The Publications Committee is looking for members to write articles for the quarterly Examiner magazine. Authors will receive six Continuing Regulatory Credits (CRE) for each technical article selected for publication.

Interested authors should contact the Publications Committee Chair, **Tian Xiao**, via **sofe@sofe.org**.

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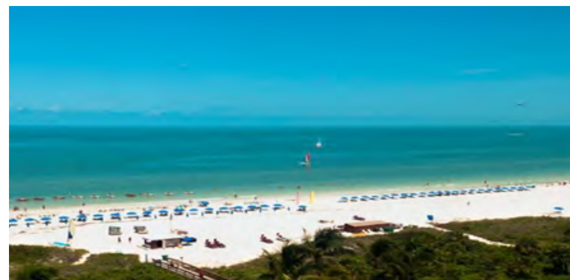
Indianapolis Downtown Marriott



2017

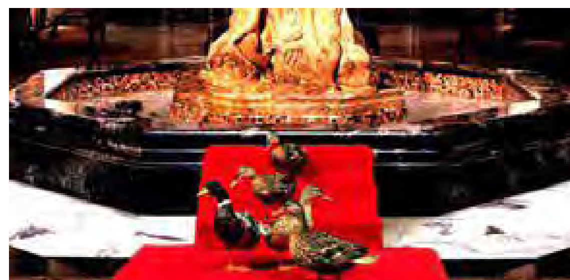
July 23–26
Marco Island, FL

JW Marriott Marco Island

2018

July 15–18
Indian Wells, CA

Hyatt Regency Indian Wells Resort & Spa



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