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The Reading Program Test from this issue and future issues of the *Examiner* will be offered and scored online.

Please see the details on the previous page.

“So, Are Accountant’s Workpapers Really Complete?”

True or False Questions — Submit Answers Online

1. FCEH guidance provides that you should notify the external auditors of the examination at least three (3) months prior to the examination as-of date
2. Early conversations between the examiners and external auditors can benefit both parties by clarifying goals and uses of the workpapers.
3. The insurer should never be bothered with examiner issues with external auditors, such as logjams from slow or no production of documents.
4. All external auditor workpapers should not be included in the external auditor’s workpapers index.
5. The new NAIC guidance related to relying on the audit work when possible is more important than ever to examiners and the Company because it allows us to focus on larger matters.

“Actuarial Guidelines and the Financial Examiner”

True or False Questions — Submit Answers Online

6. Actuarial Guidelines (AG) were created to give guidance to examiners in helping apply the actuarial laws during an examination.
7. Actuarial Guidelines are not the best way to deal with compliance concerns after passage of a law.
8. National Association of Insurance Commissioners has determine that the Actuarial Guidelines in the Accounting Practices and Procedures Manual Standards are law
9. AG38 deals with Universal Life Policies
10. Financial Examiners will have to deal with two different reserving standards when Principal Base Reserving is in effect



CRE READING PROGRAM QUESTIONS

All quizzes **MUST** be taken online
(continued)

“Facts and Perspectives on the Ebola Pandemic ”

True or False Questions — [Submit Answers Online](#)

11. Ebola is transmitted only by contact with an infected person’s bodily fluids (blood, saliva, sweat.)
12. If the Ebola virus spreads to infect tens or hundreds of thousands of adults in Africa, it is not likely not to trigger many life or health insurance claims there.
13. In the unlikely event the Ebola virus spreads to tens of thousands of adults in the US, the financial impact will be unmanageable. This is because 90% have life insurance through work at a full year’s wages and another 75% have individual life insurance with death benefits in the \$300,000 range.
14. For Life and Health, as well as Property & Casualty insurers, reinsurance will mitigate the financial effect of a surge in claims, which are likely to be very costly to treat
15. Property and Casualty insurers will be affected only in the Workers Compensation line of business, no other lines are subject to impact from the Ebola virus.

“Reviewing SOC Reports: What an Examiner Should Look For.”

True or False Questions — [Submit Answers Online](#)

16. All three Service Organization Control (SOC) Reports, SOC 1, SOC 2 and SOC 3 are equivalent in terms of the information that they contain.
17. SOC reports are categorized as Type 1 and Type 2.
18. SOC 1 reports are designed to be “throughout a period of time” and SOC 2 reports are designed to be “as of a specific date.”
19. Within the SOC report, the Service Auditor’s Report contains the following information: Scope of the engagement, Type of the SOC report, Audit period covered, CPA’s opinion on the design and operating effectiveness of the organization’s internal controls.
20. Within a SOC report, the respective CPA is responsible for the description of the controls.



CRE READING PROGRAM QUESTIONS

All quizzes **MUST** be taken online

(continued)

NAIC Fall 2014 Meeting Notes

True or False Questions — [Submit Answers Online](#)

21. The Executive Committee approved the appointment of a special task force on cybersecurity, which will make recommendations on cybersecurity issues, coordinate efforts with other NAIC Groups, and communicate with other organizations on cybersecurity issues.
22. Actuarial Guideline 48 (AG 48), Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued under Section 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation (Model 830) was adopted at the Fall Meeting with New York and Delaware dissenting and Minnesota abstaining.
23. The Corporate Governance Working Group adopted the Corporate Governance Annual Disclosure Model Act and the Corporate Governance Annual Disclosure Model Regulation as Part A Accreditation Standards.
24. The Risk Focused Surveillance Working Group adopted changes to existing examination and analysis procedures to eliminate redundant efforts during the collection and review of insurer information for solvency monitoring purposes.
25. Terrorism Insurance Implementation Working Group was monitoring federal efforts to extend the Terrorism Risk Insurance Act (TRIA) until it was passed by the Senate on December 31, 2014 and will not expire.



So, Are the Accountant's Workpapers Really Complete?

By **April Spevak, CFE** and
Lewis Bivona, CPA, AFE,
Insurance Examiners for The INS Companies

As my sainted father used to say "Are you done with (insert task) or what?" The answer always seemed obvious, if I had completed what he asked, like taking out the trash, I was done. But what he really meant was, in former Marine parlance, have you not done just the minimal amount necessary, but have you done everything required to have successfully completed the task? As I got older I came to realize that there was more truth in that phrase. If I had taken out the trash but failed to put the lid back on the garbage can, you could expect that a raccoon or a neighbor's dog would have made a mess.

Every examiner has been faced with the quandary of "are the accountants workpapers complete, accurate and relevant to what we are trying to accomplish in a risk focused examination (RFE) or what"? During a recent examination, April and I pondered this same dilemma within the context of the exams we had undertaken over the years and the issues we had faced; some questions were basic, like did we get everything that we requested and secondly, do we really know what they gave us? Sounds simple, but the answers to these questions are not always that obvious.

If the examination team requested access to the workpapers to expedite the examiners' progress, did we get what we asked for, or worse yet, did we ask for what we wanted? The guidance provided within the NAIC's Financial Condition Examiners Handbook (FCEH) is to, with the assistance of the Company, notify the external auditors of the examination at least six months prior to the examination as-of date, if possible. Our best practice is to interview the audit staff and review CPA workpapers early in the planning phases of the examination. We have found that a lot of questions that come up, and the potential wasted time trying to figure out the answers, could be avoided if communication and review are accomplished preemptively. In a number of instances, the external CPAs sent the examiners an index of workpapers which matched up to the workpapers provided; however, further examination of the workpapers indicated they were not complete. We found out after the fact that supporting schedules, hyperlinked materials and conclusions were not included. That, in turn, resulted in a lengthy re-request and lost time waiting for CPA work that would allow us to properly access the information needed to determine the possible reduction in our review of financial reporting risks.

Often times, audit firms are not familiar with the RFE process. They do not understand that their work could allow examiners to focus on a narrower band of risks, reduce both control and substantive testing and, as a result, allow the examiner to complete the examination more expeditiously. Even with firms that are familiar with the RFE process, this issue can remain since auditors that perform examination work are not always part of the attest group which performs the certified audits. Early conversations between the examiners and attesting external CPAs can benefit both parties by clarifying goals and uses of the workpapers that are not evident in the standard release and confidentiality documents sent to them by their client and the examining state.



So, Are the Accountant's Workpapers Really Complete?

(continued)

Several other positive outcomes of early onsite review and examination of workpapers can be obtained if the right questions are posed or proper persuasion is leveraged:

- **Sometimes you get what you ask for:** Ask for all of the workpapers. The worst they can do is say no. Some firms have given it all to us right up front so there was no need to continually go back and forth with requests. While we don't use ALL of it, it's better sometimes to have more information than less. If they say no, see if you can have read-only access to their projects. If they won't give you everything, it's useful to see how their work is laid out and make your requests that way. Then you don't run into the issues of missing conclusions or descriptions of the work they did.
- **Use the Company as leverage:** If you are hitting a logjam with the CPA firm over production, let the insurer know. We have had many slow poke turnaround requests promptly once the CFO or CEO called the managing partner. Another one of our favorite versions of a put off is that our request for workpapers will cost the client too much money. Guess what? Reperforming work that the CPAs did by examination staff will be so much more expensive. Make sure you let the CEO or CFO making that call aware of that fact, if necessary.
- **What do headings mean on the accountants workpapers?** Unless you are dealing with a national firm consistently, different firms name workpapers different things. Some firms, for example, include all investment work in cash, while others don't. Every workpaper should include the client's name, the workpaper's purpose, and the period under audit.
- **Workpaper Indexing:** Like a book, every workpaper has a unique page number showing its place in the audit file. Every workpaper should be included in the index so that the examiners can select the ones they desire copies of from the CPA while omitting the workpapers that add little or no value to the examination. It is also important that copies of workpapers requested maintain the same indexing scheme as the original index for ease of retrieval. We have found that some firms will give you the workpapers but remove the alpha or numeric sequencing that was in the index, which is bad news for the examiner trying to cross reference to another workpaper.
- **Cross-referencing:** This is usually not a problem in CPA workpapers but can be an issue if they produce workpapers without hyperlinks or, as they often do, give you PDF copies of workpapers. PDFs often lose linkages; in this case, make sure that the CPAs cross references are such that they are not removed or subverted by the copying process.



So, Are the Accountant's Workpapers Really Complete?

(continued)

- **Tick marks:** Although some tick marks are generally universal, like "F" for footed, it is still necessary and prudent to get a copy of the firm's tick marks just in case!
- **Source of information:** The source of the information should be on every workpaper and can be represented by a tick mark (see above). Be sure to review the workpapers for the person the auditor spoke with that is responsible for representations made on the workpaper. Although the auditor may know who the A/P clerk was at the point in the audit, you may have to revisit that person for follow up questions or information. Some auditors will state a person's name without their title. It does not hurt to ask for clarification now versus later.
- **A conclusion:** Did the audit team write a summary of the results of the work they performed? Can you understand how the work they performed supports their conclusion? If so, great; if not, ask for clarification as sometimes the firm's quality assurance department does not catch every workpaper, only the ones that they thought were material.
- **SALY: (same as last year):** if testing on a particular account or control in the prior year was deemed sufficient, the CPA may not have repeated that work in the year's workpapers you are reviewing. That factor necessitates asking about prior year work and requesting a copy of the work performed. Again, better to ask for key risk areas you have assessed as Critical Risk Categories (CRC's) now rather than later. For that matter, asking for any passed adjustments for all years might also be prudent as that could be an indicator of a potential smoldering problem.
- **Sampling:** Ask for a copy of the firm's sampling methodology. Does it line up with NAIC sampling standards or not? If not, it would be better to know where control sampling comes up short so you can plan to remediate/supplement the testing now.
- **Can we talk about formatting?**- Don't assume that because it looks good on the accountant's PC it will look the same when you get the file. Set viewing expectations. In one examination we received awful PDFs that you would have to print out and arrange 8 pages to see what they were trying to document. Also, if it's a PDF, sometimes they'll only give you the first tab in a pdf when there are 18 more tabs that you needed to see. If you address these issues up front, it shouldn't be a traumatic distraction during field work.



So, Are the Accountant's Workpapers Really Complete?

(continued)

The new NAIC guidance related to relying on audit work when possible is more important than ever to both the examiners and to the Company. It allows us to focus on the larger matters such as solvency, competition, regulatory, governance and strategic challenges while creating a more cost effective and timely exam for the Company. While this guidance is not all encompassing, it is a great start for making sure you are not short sheeted prior to your insurer fieldwork. Better to ask early, than saying "what the heck?" in Phase 3!

April Spevak, CFE

Ms. Spevak currently functions as a senior examiner for the INS Companies where her primary responsibilities include financial examinations on Life, Health, Property and Casualty and Reinsurance Companies. Prior to joining the INS Companies, Ms. Spevak worked at the Pennsylvania Insurance Department for seven years where she functioned as both a financial examiner and examiner-in-charge.

Lewis D. Bivona, Jr. CPA, AFE

Lewis (Lew) has over 36 years of experience in the healthcare/insurance industry, 30 of which are in managed care. The depth of his experience has been garnered from high-level positions within the HMO, consulting and hospital industries as well as a period in HMO regulation.



Actuarial Guidelines and the Financial Examiner

By **David J. Hippen, FSA, MAAA, FLMI**
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Disclaimer: This article represents my personal opinions, not those of my employer or of any client or state for which I am or have been employed. I am not a lawyer. Although I have extensive experience as a regulator, the thoughts expressed are intended as helpful information and opinion, not interpretations or official guidance.

Introduction

Most of you know that wise use of the NAIC's Financial Condition Examiners Handbook of Instructions includes appropriate consideration of the NAIC Actuarial Guidelines (AGs). But you might not know why they exist, or how to use them. This article is intended to help readers understand what they are, what they are not, and how to apply them, e.g., in examining insurers.

I. NAIC Actuarial Guidelines (AGs)

A. What AGs are intended to be

1. Additional actuarial assistance for financial examiners

Some legal requirements, including those which regulate or describe actuarial practices, can be awkward to apply to a specific situation. It can be very difficult for a legislative body to completely describe some actuarial requirements in terms that fit well within the framework of a state's laws. To enable financial examiners to apply those laws and test compliance of actuarial items with the law, NAIC Actuarial Guidelines were created to give guidance to examiners in reviewing insurance company statements, reports, and practices.

2. Technical clarifications of the law, especially actuarial aspects

Many laws, especially statutes (i.e., laws passed by legislatures), only provide the primary principles to be followed, leaving the details to regulations to be promulgated by administrators (e.g., insurance commissioners). Even in instances where laws do a good job of explaining actuarial issues, compliance concerns can arise subsequent to the passage of the law which can best be dealt with via clarification in an AG (i.e., as long as the clarification is supportable by the underlying law, and not a change or interpretation of the law). An AG that explains how to apply a specific law can be helpful to both insurers and regulators, and help to keep the legal "playing field" level.



Actuarial Guidelines and the Financial Examiner

(continued)

3. Applicable to all policies issued on or after effective date of underlying law

The NAIC is not a regulatory body, but an association of regulators whose authority varies by and is specific to a jurisdiction (i.e., state, territory, district). In general, because AGs are not adopted or promulgated by a regulatory authority, they are not considered laws or interpretations of law, but are clarifications of existing laws. As such, they can often be applicable to all policies issued and insurance company actions or reports since the effective date of the underlying law.

For example, virtually all states have adopted a version of the Standard Valuation Law. However, the effective dates of those laws varies widely from state to state. An AG that clarifies how reserves are to be established under the Standard Valuation Law could apply to all policies issued on or after the effective date in its respective state of issue, including policies issued before the AG was adopted by the NAIC.

B. What AGs are not generally intended to be

1. Not intended to be law

Many are not written in rigorous legal terms. AGs are generally intended to give guidance, not requirements, so there can be instances where conformity to an AG is not necessary in order to comply with the underlying laws. Some AGs include specific effective dates, which can create confusion as to applicability, so users should learn the legal status of an AG when analyzing a specific situation or policy.

2. Nonconformity might not mean noncompliance

If AGs are found by examiners not to be applicable to a given situation, failure to comply might not be considered a violation.

3. Not Accounting Practices and Procedures Manual (APPM) Standards

The AGs are incorporated as Appendices to the APPM (some in abridged form), which has been adopted by law in virtually all states. Some people have inferred that this means that the AGs either are or have attained the status of laws, i.e., by being a reference in the APPM. However the NAIC has rejected this suggestion, so it seems best to presume that their presence in the APPM does not automatically mean that they represent law.



Actuarial Guidelines and the Financial Examiner

(continued)

4. Exceptions

Some states have adopted AGs by rule, either with or without modifications to make their terms congruent with other laws. They could treat nonconformity with AGs as violations of the law. They could levy penalties for violation of the underlying laws.

Nonconforming companies and/or policies could be required to comply and/or subjected to sanctions even if the state has not adopted AGs by rule. However, courts could find that penalties are not appropriate, or deem the AG to be unenforceable. Some adopted AGs have included language that implies that nonconformity represents a violation of law, e.g., those with their own effective dates, reporting requirements, and regulatory applicability provisions.

C. Some noteworthy AGs

1. XXX

Many have heard of XXX reserves, but some don't know that it's actually a law. Although its initial draft was as a proposed NAIC Actuarial Guideline, it was ultimately adopted by the NAIC as the Valuation of Life Insurance Policies Model Regulation. Regulations are considered laws when states adopt them.

For trivia buffs: The name "XXX" comes from its proposed AG days. NAIC Actuarial Guidelines are officially numbered using Roman numerals. XXX was initially expected to become the 30th AG (Roman XXX = 30).

2. AG 35

This was initially drafted as AG ZZZ (in part to help avoid the confusion that followed when AG XXX became a model regulation instead of an actuarial guideline). It was adopted as AG 35, but is generally used in lieu of a direct application of the Standard Valuation Law (SVL). In states where AGs are adopted as regulations, it is considered the law, but most states follow it as if it were the law, because it would otherwise be unclear from the SVL how to establish reserves for indexed annuities.



Actuarial Guidelines and the Financial Examiner

(continued)

3. AG 38 (aka AXXX)

This guideline was intended as a supplement to XXX for UL policies. While XXX became a model regulation, AXXX was adopted as an Actuarial Guideline. This could make its applicability differ depending upon its status with regard to a state's laws.

A further complication is that AG38 was significantly revised by the NAIC, with different provisions applying to UL policies depending upon their contract language and issue date. This was a result of a controversy over its application to UL with secondary guarantees (i.e., contract provisions that permit the contract death benefit to continue despite cash value dropping to 0). Examiners must be very cautious in testing compliance with AG38, not only because its application is complex, but because its legal status in some states continues to be very controversial.

4. AG 43

AG43 is generally applicable to guarantees offered as part of or in conjunction with variable annuities. Its provisions and current application are seen by many as a precursor to Principle-Based Reserves (PBR). PBR is currently being proposed for adoption by state legislatures to be effective nationally, and its Valuation Manual could take the place of any future NAIC Actuarial Guidelines, with adoption via state legislatures eliminating most questions as to their legal standing.

II. Practical Application of Actuarial Guidelines

A. Use of Actuarial Guidelines by Actuaries and Company Staff

1. When Applicable

If applicable, conformity is generally expected. When AGs have been adopted as regulations, nonconformity likely means that a law has been violated. But even when an AG is not considered to be state law, nonconformity could often mean that the actuarial aspects addressed by the AG are not in compliance with model laws.

2. When not applicable

When an AG is the law, it clearly must be followed. Some AGs were written with limited applicability, but the determination of applicability should be made by an actuary qualified to make such a decision. In such cases, the actuary should generally file an internal memorandum of explanation, which the examiner could use.



Actuarial Guidelines and the Financial Examiner

(continued)

3. If domiciliary state has adopted by rule

When AGs are state regulations, legal compliance may be required. Examiners should discuss their status with the domiciliary state insurance department to determine the state's position. It would be wise to assume that conformity is required.

4. If domiciliary state has not adopted AGs by rule

If applicable to individual policies issued out of state, and the state of issue has adopted AG(s) by rule, the laws of the state of issue might require compliance with an AG. This could be very complicated if the domiciliary state has not enforced conformity. Examiners should discuss this complication whenever it arises.

B. Examining for Conformity to Actuarial Guidelines

1. Examiners need to know the legal standing of AGs in the examining state, e.g., whether the state has adopted any or all AGs by rule, whether the state has issued any bulletins or official notices regarding them, and which underlying laws might be applicable.
2. Examiners should request copies of company documents which describe, explain, or relate to conformity/compliance with AGs, e.g., reports, memoranda, board minutes.

III. Actuarial Guidelines, Principle Based Reserves (PBR), and the Future

A. Applicability of AGs after PBR

1. PBR applicable only to new issues

PBR is intended to apply to policies issued after its effective date (which is expected to be 1/1/17 or later). AGs will continue to govern the actuarial issues that affect policies issued prior to the adoption of PBR. It could be very awkward to separate the standards applicable to pre-PBR business from those issued subject to PBR.



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(continued)

2. Updated Valuation Manual could change applicability of AGs

The Valuation Manual (VM), which explains the details of PBR, could be viewed as an expanded set of AGs. The VM is expected to be updated on a regular basis, with its changes adopted by the NAIC (and not necessarily by each state). This could obviate the need for many future AGs, and could also affect the applicability of existing AGs to policies reissued after PBR is effective.

B. Post-PBR Promulgation of AGs

1. Pre-PBR Policies not subject to PBR

Policies issued prior to the effective date of PBR are not expected to comply with the reserving guidance in PBR. This could mean that two different reserve standards could be required for the different blocks of an insurer's business well into the 22nd Century. Because of this, there could be some sentiment in the future for applying PBR to inforce business.

2. New AGs could be adopted specifically for post-PBR Policies

Although not initially contemplated, there could be some actuarial areas for which amending the VM doesn't seem an appropriate approach, e.g., clarifying the effects of nonforfeiture laws on some new product lines. These could be addressed by future NAIC AGs. Examiners would then need to deal with an additional layer of standards.

Conclusion

Examiners need to consider all applicable NAIC Actuarial Guidelines in order to conduct appropriate, successful and thorough exams. They should not assume that AGs are the law, or that conformity is always required. They should also not assume that AGs are not law, but seek to establish the position of the governing jurisdiction.



Actuarial Guidelines and the Financial Examiner

(continued)

David Hippen, FSA, MAAA, FLMI

David is a Life and Health Consulting Actuary at Risk & Regulatory Consulting, LLC (RRC). David has approximately 40 years experience in a wide range of life and health insurance products, including traditional life, universal life, fixed and variable annuities, disability income, and long term care. Prior to joining RRC, David was Life and Health Actuary for the Missouri Department of Insurance (MO DIFP) for over 6 years, where he was responsible for the review of all actuarial aspects of life and health filings, as well as financial review of Missouri life and health domestics. Prior to that position, he served as a Staff Actuary with both the Florida Office of Insurance Regulation and the Utah Insurance Department, and as full-time Consulting Actuary to the Vermont Department of BISHCA (dba Hippen Actuarial & Financial Services).

He has experience in a wide range of statutory valuation requirements, and has reviewed all of the filings and reports that will be part of the study during his work as a regulator. David served on LATF, HATF, and their predecessor LHATF for 9 years, and assisted Frank Dino (LHATF Chair, representing Florida OIR) in developing reporting requirements for the NAIC. As a member of the Academy's AOM Discussion Group, David was chair of the subgroup for Consolidation and Standardization of the AOM and Required Reports. In addition to contributing to the report for that discussion group, David initiated discussions with LATF (on behalf of Missouri) regarding potential improvements to the AOMR and other reporting requirements which could be considered by LATF for future improvements to regulatory reporting.

He has also been deeply involved in the evolving regulatory requirements for life and annuity products, including participation in various NAIC subgroups related to principle based reserves for life and annuity products, and chaired the NAIC LTC Pricing Subgroup as well as the C3P2/AG43 Subgroup. He wrote the introduction chapter for the forthcoming Academy LTC Credibility Monograph, and is an active member of Academy work groups on government mandates, nonforfeiture, separate accounts, annuity illustrations, and contingent deferred annuities. Besides his regulatory career, David has been on the actuarial staff of several insurance companies, both large and small, both stock and mutual, as well as managing his own consulting firm.

FACTS AND PERSPECTIVES ON THE EBOLA PANDEMIC

Insurance Industry Ramifications of the Spread of the Ebola Virus

October 13, 2014

CURRENT SITUATION

- As of October 10, the Ebola virus has infected at least 8,399 people and killed 4,035, according to the World Health Organization. This includes 4,762 confirmed cases, 2,196 probable cases and 1,652 suspected cases.¹
- As of October 10, all but four of the cases were in four countries in Africa (Guinea, Liberia, Sierra Leone, and Nigeria). One was in Senegal, one in Spain, and (as of October 12) two in the United States.
- There are five known strains of the Ebola virus. The one causing the illness and deaths noted above is the Zaire strain, which was identified in 1976.
- There is currently no cure and no vaccine for this virus. Treatment is isolation (to prevent spread) and focus on symptoms—mainly dialysis and fluids to prevent dehydration and reduce fever.
- The mortality rate of infected people to date is roughly 50 percent.
- Unlike influenza viruses, the Ebola virus is transmitted only by contact with an infected person's bodily fluids (e.g., blood, saliva, sweat, diarrhea, vomit, etc.) during the incubation period or shortly thereafter. Contact with the fluids could be from contact with sheets, mattresses, medical equipment or any other surface to which the fluids were transferred.

EXPECTED NEAR-TERM HEALTH-CARE SITUATION

- In the U.S., the Centers for Disease Control and Prevention (CDC) does not expect the Ebola virus to infect people other than a small number of health-care workers and others who have had direct contact with the bodily fluids of an infected person.
- However, the CDC is investigating the confirmed case (on October 12) of a health-care worker in Dallas who had treated an infected person, because it does not know how the health-care worker acquired the virus, and this might suggest weaknesses in the isolation/prevention protocols.

WORST-CASE SCENARIO

If the number of cases in Africa continues on its exponential ascent, the number of people who might carry the virus elsewhere around the world will also grow. The number of cases in Africa is likely to grow if isolation of the sick, tracking their contacts,

¹ Source: World Health Organization:

http://apps.who.int/iris/bitstream/10665/136161/1/roadmapupdate10Oct14_eng.pdf?ua=1.

and careful procedures followed by health-care workers, proves to be inadequate. An especially concerning scenario is the travel of infected people from Africa to India,

China or other heavily populated countries, where there are billions of people living in many densely-populated cities with relatively weak health-care systems.

Another element of a worst-case scenario would be screening systems at U.S. and other ports of entry that are ineffective in identifying people carrying the virus. This was how both the U.S. and Spanish cases gained entry into their respective countries. If improvements in screening are not completely effective, additional infected individuals could enter countries around the world, potentially leading to the spread of Ebola in the developed world and beyond.

Another threat is the possibility that the virus could mutate into one that is more virulent—producing a higher death rate. This might also increase the ease of spread of the virus.

EFFECT ON THE LIFE AND HEALTH INSURANCE INDUSTRIES

- The effects on the Life and Health insurance industries will clearly depend on whether the infected people are insured. Some of those who have died up to now were children and almost certainly did not have life insurance.
- Even if the Ebola virus spreads to infect tens or even hundreds of thousands of adults in Africa, it is not likely to trigger many life insurance or health insurance claims there. Life insurance coverage in the three most affected countries—Guinea, Liberia and Sierra Leone—is extremely low. Indeed, in Swiss Re’s most recent report on life premiums per capita (for 2013), the calculation for all three of these countries is so small that none makes the list.
- Even in the unlikely event that the Ebola virus spreads to infect tens of thousands of adults in the United States, the financial impact will likely be quite manageable. This is because perhaps one-third of adults in the U.S. have life insurance only through their employment, and the amount is typically equal to one year’s income. Another one-third have individual life insurance, with the average death benefit in the \$200,000 range. In a typical year life insurers pay about 2 million death claims, so another 100,000 would be only 5 percent more than typical. Moreover, most life insurers are well capitalized, and even the largest life insurers have reinsurance to prevent a surge in death claims from imperiling their solvency, so that the net effect would likely be, at most, a reduction in the profit they would otherwise record.
- The cost of caring for Ebola cases would likely be at the high end of health insurance claims, and the effect on health insurers would depend on the number of people suspected of being infected. Many people would need to be tested to see whether they have contracted the virus, and the cost of isolation of those affected could be substantial. Note that some individuals may have no health insurance, as was the case with the index (first)

patient who died of Ebola at a Dallas hospital on October 8. In such cases, treatment costs will likely be borne outside the private health insurance system.

EFFECT ON THE PROPERTY/CASUALTY INSURANCE INDUSTRY

- The main effect on the Property/Casualty insurance industry would likely be on companies writing Workers Compensation insurance because health-care workers could be most directly exposed (as happened in Texas and in several African countries). Workers Compensation pays for the cost of medical care and lost income for people who become ill in the course of their work, and pays death benefits if they die from a work-related cause. As with life insurance, it is unlikely that many workers in the main affected African countries have workers compensation-type coverages; the latest Swiss Re report indicates that the level of premiums per capita for all non-life insurance coverages combined (not just Workers Compensation) in the three most-affected countries is so low as to not be listed. In the United States, in contrast, Workers Compensation coverage is nearly universal, but the likelihood of claims is low, assuming that employers and their workers take CDC-recommended precautions. As with life insurance coverage, reinsurance will help mitigate the financial effect of a surge in claims, which are likely to be very costly in the event of actual work-related infections.
- Other possible effects might be on various liability insurance lines. These include General Liability, Directors & Officers (D&O) Liability and Medical Malpractice (Med Mal) Liability. General liability and D&O claims might be filed asserting that the policyowner was negligent in failing to prevent transmission of the virus. For example, a claim might be filed alleging negligent disposal of contaminated waste, pursuing either General Liability or Med Mal recovery. Med Mal claims might assert that proper medical protocols were not followed, resulting in infection by the Ebola virus, or that the disease was not properly diagnosed or diagnosed in a timely manner or that the treatment protocol itself and/or care rendered was somehow negligent. At this stage it is impossible to forecast the precise number of such claims or the amounts of damages that might be sought. That said, assuming the CDC's protocols are successfully followed, the number of Ebola cases should be small, thereby limiting the number and likelihood of tort actions that can impact various liability coverages.



Reviewing SOC Reports: What an Examiner Should Look For

By **Brent Reese, CPA, CITP, CISA,**
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When I decided to write an article about reviewing SOC reports I thought it would be an easy, straight-forward task. I perform a lot of SOC 1 audits, so navigating the 80+ page document is almost second nature to me. As I started outlining my notes, I quickly realized how broad the scope could become and I had to struggle to keep the scope as focused and concise as possible. I have described here what I believe are (or should be) the bare essentials to reviewing a SOC report not only for Financial Examiners, but any auditor or member of Management. Most (if not all) of the following points could easily be expanded as stand-alone articles.

Note: SOC 1 and SOC 2 reports are laid out in essentially the same format and include the same key elements. SOC 3 reports are of little use to an examiner since they do not include a description of the tests performed, results of tests, or the CPA's opinion. For the purposes of this article, references to "SOC" reports is intended to include both SOC 1 and SOC 2 reports.

Understand What A SOC Report Is

In a nutshell, SOC 1 Reports are reports issued by a Certified Public Accountant (CPA) that include the CPA's opinion on 1) the *design* and 2) *operating effectiveness* of a service organization's internal controls. Specifically, internal controls that are relevant to user entities' financial reporting. User entities (clients of the Service Organization) and their auditors use SOC 1 reports to evaluate the Service Organization's internal controls over financial reporting for purposes of complying with regulations such as the Sarbanes-Oxley Act and planning and performing audits of user entity financial statements.

SOC 2 Reports are basically the same as SOC 1 reports, but rather than focusing on internal controls relevant to a user entities' financial reporting, the focus is on controls related to predefined criteria. For example, controls surrounding Security, Availability, Processing Integrity, Confidentiality, and Privacy.

There are two types of SOC reports, Type 1 and Type 2. To oversimplify, Type 1 reports are as of a **specific date** (i.e., at December 31) and Type 2 reports are **throughout a period of time** (i.e., January 1 through December 31). Type 2 reports are the most reliable.



Reviewing SOC Reports: What an Examiner Should Look For

(continued)

Why do examiners review SOC Reports?

The technical answer is that ultimately, examiners want to determine whether financial solvency risks to the insurer have been mitigated. Part of the examination planning process should include obtaining and reviewing the insurer's SOC report. The reality is that a lot of time, reviewing the insurer's SOC report is nothing more than a "checklist item" and a detailed review is often not performed.

Insurers go through a lot of trouble and expense to successfully get through a SOC audit since almost every key functional area of the company is in scope (much like an examination). No, not every area an examiner is interested in will be covered in a SOC report, but there is usually some common ground. If nothing else, a SOC report can provide the examiner with a backdrop of the corporate organizational and control structure. For example, most SOC reports will include a description of the company's Corporate Oversight controls, explanation of the fraud and compliance program, an organization chart, and detailed transaction and IT General control descriptions. These are all things examiners are concerned about.

What to Look for When Reviewing

So what should you look for when reviewing a SOC report? Here are my suggestions.

Start at the beginning (the Service Auditor's Report)

I don't recommend this, but if you don't read anything else, *read the Service Auditor's Report*. Within this section you will find the scope of the engagement (which processes and transactions were included in the audit), the type of SOC report (i.e., Type 1 or Type 2), the audit period covered, and the CPA's opinion on 1) the design and 2) the operating effectiveness of the organization's internal controls over the transactions in scope during that audit period.

A CPA might qualify their opinion if they determine the service organization's internal controls have not been designed adequately to achieve the control objective(s) and/or the internal controls in place were not operating effectively and impaired the organization's ability to achieve the controls objective.



Reviewing SOC Reports: What an Examiner Should Look For

(continued)

Description of Controls in Place

As painful (and obvious) as it may seem, I urge you to actually read the entire description of controls. You will be surprised at how much you will learn from reading this description. Management is ultimately responsible for the contents of the description, so this is the company's, not the CPA's, explanation of how things are done. There are lots of little "nuggets" of information begging to be uncovered here. For example, a description of the claims adjudication process may include a discussion about a Management monitoring report, but from a risk standpoint that report may be key in mitigating a particular risk an examiner is concerned about.

You might also find additional language explaining the scope of the audit in this section. For example, there may be a statement explaining both the transactions included in the audit and transactions explicitly not included. This is particularly useful if the insurer has several lines of business or is geographically diverse.

Controls Expected at User Entities

Pay particular attention to this section. This is where the insurer lists the controls they expect their customers to have in place. The examiner should assess whether or not these expectations are reasonable. I am not saying you should start contacting the insurer's customers, but a simple assessment should do. You're looking for "red flags". Look for things that are unusual. For example, a self-insured customer may be expected to perform bank reconciliations and eligibility determinations; this is not unusual. But you might want to follow up if that customer is also responsible for key management or oversight duties. It is possible the customer has not been made aware of this expectation, the insurer is not performing the control, and therefore, a risk somewhere is unmitigated.

Note Third Parties Used

Third Party Service Providers are used by almost every company. An insurer may be great at writing insurance policies and adjudicating claims, but not so hot at printing checks. In this instance, the insurer may outsource the check printing process and that vendor should be listed in this section of the SOC report. The examiner should read and understand this section if for no other reason, to understand what functions the insurer does not perform. And again, consider that in your risk assessment.



Reviewing SOC Reports: What an Examiner Should Look For

(continued)

Tests Performed and Results

This is the section I would bet most of you reading this article already focus on. That is not a bad thing. This is the meat of the SOC report. In a well written SOC report, this section should summarize the key controls noted in management's description and the auditors' tests should be designed and explained in a clear and convincing manner. The most common types of tests you will see in a SOC report are:

- **Inquiry** (the auditor made inquiries with Management and staff regarding the existence of the control in place, frequency of control, evidence of control, etc.)
- **Inspection** (the auditor inspected evidence of the control such as documents, reports, screenshots, flowcharts, etc.)
- **Observation** (the auditor observed the control being applied in practice)
- **Reperformance** (the auditor independently reperfomed the control)

The general rule of thumb here is that the more types of tests performed on a control, the more convincing the results. If the tests performed on a key control were only described as "Inquiry" type tests, the results may not be very convincing.

When reviewing the testing and results section, Examiners should consider whether or not the tests of controls performed appear to be adequate, does the result give assurance that the control was in place and functioning during the audit period, how does this affect your risk assessment?

Unaudited Information

Sometimes, not always, management of the insurer will choose to include unaudited information at the end of the SOC report for informational purposes. This could include responses to testing exceptions and management's action plans, descriptions of the company's disaster recovery plan, or complex diagrams that may help illustrate a particular process. The examiner should take these unaudited assertions into consideration when performing their risk assessment.



Reviewing SOC Reports: What an Examiner Should Look For

(continued)

Summary

Hopefully by now you have gathered that there is more to reviewing SOC reports than testing exceptions and that the information contained in these reports can be used to your advantage. I wish I had a quick tip for reviewing SOC reports like “always look at page 14, you will find what you need there”, but it isn’t that simple. What I hope I have shown you is that there are many considerations to be had and several items to look out for when reviewing a SOC report. Instead of checking off the “Review SOC Report” box on an audit program, try answering these questions as you review each item of the report; 1) What is the risk? and 2) How does it impact my examination?

About the Author

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NAIC Meeting Notes

Global Insurance Industry Group, Americas

NAIC 2014 Fall National Meeting

The National Association of Insurance Commissioners held its Fall National Meeting in Washington, D.C. November 16-19. This newsletter contains information on activities that occurred in some of the committees, task forces and working groups that met there; the Newsletter also covers interim meetings subsequent to the Fall National Meeting through December 17, including the December 15th Executive Committee and Plenary conference call. 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 appointed a new task force to address cybersecurity issues and elected its 2015 officers.
- The Financial Condition Committee agreed to a new project to evaluate risk transfer on P/C reinsurance contracts with risk limiting features.
- The Statutory Accounting Principles Working Group adopted SSAP 107, Accounting for the Risk Sharing Receivables of the ACA, and SSAP 40R to address wholly owned single real estate property in an LLC. The working group also continued discussion of its investment classification review project.
- The PBR Implementation Task Force adopted AG 48 related to XXX/AXXX captives after months of significant effort and exposed the PBR Small Company Exemption Proposal after heated debate.
- The Capital Adequacy Task Force exposed a proposal to modify the RBC treatment of derivative transactions.
- The Life RBC Working Group continued work on its responses to the XXX/AXXX Reinsurance Framework RBC referrals, two of which were exposed for comment during the working group's December 17 conference call.
- The Investment RBC Working Group discussed feedback received on the AAA's recommended factors for public corporate bonds used in the life RBC calculation. The working group is also considering whether real estate factors should be adjusted for property type or geographic region. Initial steps are underway to develop P/C and health RBC asset risk factors, but there is some opposition to using the life factors as a starting point.
- The Operational Risk Subgroup continued its evaluation of operational risk types, assessing its working definition of operational risk and exploring a potential operational risk database.
- The Property/Casualty RBC Working Group exposed a revised RAA reinsurance credit risk charge proposal.
- The Catastrophe Risk Subgroup discussed comments on an industry proposal on methodologies for calculating the R6 and R7 charges, comments on the contingent credit risk proposal, and discussed the catastrophe risk charge exemption proposal.
- The Health RBC Working Group continued discussion of the excessive growth charge proposal.
- The Valuation of Securities Task Force adopted several significant amendments to the Purposes and Procedures Manual, continued discussion of private letter ratings and the related Filing Exempt process and approved the assumptions for the 2014 RMBS and CMBS financial modeling.
- The Group Solvency Issues Working Group completed its revisions to the Insurance Holding Company Model Act to provide guidance on group-wide supervision of internationally active insurance groups.
- The ComFrame Development and Analysis Working Group discussed the proposed IAIS global capital standard and the NAIC's development of a potential domestic group capital standard.
- The Reinsurance Task Force approved seven countries as Qualified Jurisdictions: Bermuda, Germany, United Kingdom, France, Ireland, Japan and Switzerland. The task force also adopted the Uniform Application Checklist for Certified Reinsurers.
- The Blanks Working Group adopted a new Supplemental XXX/AXXX Reinsurance Exhibit to the Life and Fraternal annual statement for 2014 year-end reporting.
- The Unclaimed Life Insurance Benefits Working Group recommended that the NAIC develop an Unclaimed Life Insurance Benefits Act to provide consistency related to the processes for locating and paying beneficiaries.
- The Life Actuarial Task Force discussed the proposed actuarial guideline for Indexed Universal Life policy illustrations and heard comments from different groups in support of two alternative proposals. The task force also continued work on Valuation Manual amendments and exposed proposed revisions to

the *Synthetic Guaranteed Investment Contracts Model Regulation*.

- The Emerging Actuarial Issues Working Group adopted the proposed AG 38 interpretation permitting the delinking of liability cash flows and asset net investment returns in calculating the gross premium reserve.
- The Health Actuarial Task Force continues to focus on reserving issues related to long-term care insurance.
- The Financial Regulation Standards and Accreditation Committee directed NAIC staff to draft new versions of the preambles to the NAIC accreditation standards in response to strong objections to its “multi-state insurer” proposal.

- The Risk-Focused Surveillance Working Group completed the revised Insurer Profile Summary templates for solvency oversight and referred them to the Financial Analysis Handbook Working Group and the Financial Examiners Handbook Technical Group for consideration of adoption.
- The Mortgage Guaranty Insurance Working Group continued discussion on its draft *Mortgage Guaranty Insurance Model Regulation* and development of a comprehensive standards manual.
- The Terrorism Insurance Implementation Working Group continued to monitor renewal of the Terrorism Risk Insurance Act. As Congress did not renew the Act before they recessed for the year, TRIA will expire at December 31, 2014.

Executive Committee and Plenary

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

2015 Election of Officers

During the Fall National Meeting, the Executive Committee and Plenary elected the following officers:

- Commissioner Monica Lindeen (MT), President
- Commissioner Michael Consedine (PA), President-Elect;
- Commissioner Sharon Clark (KY), Vice-President; and
- Commissioner Ted Nickel (WI), Secretary-Treasurer.

Commissioner Marguerite Salazar (CO) ran against Commissioner Nickel for the position of Secretary-Treasurer. The remaining executive positions were unopposed.

Adoption of New or Revised Models

The Executive Committee and Plenary adopted the following items at the Fall National Meeting, which were the subject of public hearings and debate as they were considered by various groups of the NAIC:

- Corporate Governance Annual Disclosure Model Act and Regulation

- Guideline for Payment of Interest to Receiver on Overdue Reinsurance Recoverables
- 2011 revisions to the *Risk-Based Capital for Insurers Model Act* regarding the Life Trend Test for Accreditation purposes.

During a subsequent conference call held on December 16, Executive Committee and Plenary also adopted the following additional items, which had not been ready for final adoption in Washington D.C.:

- Actuarial Guideline XLVIII (AG 48) (See discussion on page 6)
- Revisions to *Insurance Holding Company System Regulatory Act* to adopt the concept of group-wide supervision of international active insurance groups (see page 19)
- Approval of seven Qualified Jurisdictions under the Process for Developing and Maintaining the NAIC List of Qualified Jurisdictions (see page 21)
- *Individual Market Health Insurance Coverage Model Regulation*
- *Small Group Market Health Insurance Coverage Model Regulation*

Executive Committee

In Washington, the committee approved the appointment of a special task force on cybersecurity, which will make recommendations to the Executive Committee on cybersecurity issues, coordinate related issues with other NAIC groups, and communicate with other organizations on cybersecurity issues. Among other topics, the task force will study the protection of information housed by insurance departments and the NAIC, and the protection of consumer information collected by insurers. The task force will also obtain information on cyber-liability policies being issued by insurers.

Governance Review Task Force

During the Fall National Meeting, the chair provided an update of the consultant selection process, which will be engaged to perform “a review of [the NAIC’s] governing documents, organizational structure, management and decision-making processes and recommend revisions or improvements to comply with best practices for comparable organizations and to enhance the NAIC’s ability to support and improve state regulation of insurance.” The task force received six proposals and plans to share its recommendation with the Executive Committee by year-end.

Financial Condition Committee

During the committee’s meeting in Washington, the chair informed the regulators and interested parties of a proposed new charge to “develop regulatory guidance on how to evaluate risk transfer as it pertains to contracts with risk limiting features and also evaluate how current actuarial/accounting practices used to monitor a company’s financial strength need to be enhanced due to distortions from these contracts.” The chair suggested that a new working group be established of property/casualty actuaries and other regulators to study the issue. During its conference call on December 12, the committee adopted the charge with the chair requesting regulators interested in working on the project to contact NAIC staff.

Statutory Accounting Principles Working Group

The working group discussed the following projects at the Fall National Meeting, with a subsequent conference call December 12 to adopt proposals with year-end 2014 or January 1, 2015 effective dates.

(After each topic is a reference to the Statutory Accounting Principles Working Group’s agenda item number.)

Insurer Accounting for the Affordable Care Act

Accounting for the Risk-Sharing Provisions of the Affordable Care Act (2014-12) – During the Summer National Meeting, the working group reached a consensus to redraft the exposed issue paper as follows: 1) replace the non-admission guidance with criteria that incorporates “conservatism and sufficiency of data” in estimating the risk adjustment and risk corridor receivables, and 2) remove the exposed 90-day aging guidance and add language to be consistent with other government receivables. The revised issue paper was released on October 24 and at the Fall National Meeting the working group briefly reviewed comments received in a joint AHIP/BCBSA comment letter. The regulators agreed to all the comments, including clarifying guidance for the 2014 disclosure rollforward, and then adopted Issue Paper 150 as final. The disclosure requirements have been clarified so that the roll-forward of prior year ACA risk-sharing provisions balances will show zero for all amounts for this year-end since 2014 is the first year that a receivable or liability will be recorded.

SSAP 107, Accounting for the Risk Sharing Receivables of the ACA, was exposed for public comment with a shortened comment period ending December 8 to allow adoption by the working group by year-end. The conclusions proposed in the SSAP are consistent with those in Issue Paper 150 and the proposed effective date is for years ending on or after December 15, 2014. During the December 12 conference call, the working group discussed a comment letter received from a trade organization in support of the proposal. SSAP 107 was then adopted by the working group, the Accounting Practices and Procedures Task Force and Financial Condition Committee during the December 12 joint conference call and by the Executive Committee and Plenary on December 16.

Adoption of New Standards or Revisions to SSAPs

Restricted Assets Disclosure (2014-16) – The working group adopted revisions to SSAP 1 and SSAP 4 to clarify that all assets pledged as collateral or otherwise restricted shall be reported in the restricted asset disclosure regardless of whether the asset is considered an admitted asset.

Separate Notes Disclosures (2014-18) – The working group adopted proposed changes to SSAP 56 and annual statement notes 32 and 34 (related to reserves by withdrawal characteristics) to make them consistent.

Clarifications of INTs Incorporated into SSAP 55 (2014-19) – The working group adopted proposed revisions to SSAP 55 to clarify the original intent of the guidance from INT 02-21, Accounting for Prepaid Loss Adjustment Expenses and Claim Adjustment Expenses, and INT 03-17, Classification of Liabilities from ECO Lawsuits. NAIC staff noted that when the INT guidance was transferred to SSAP 55, some of the detail was not fully integrated.

Clarification of the Income Tax Footnote (2014-20)
The working group adopted a revision to SSAP 101, footnote 3, to clarify that the RBC ratio for purposes of the year-end DTA admissibility test is the ratio from the current reporting period being filed.

SSAP 57 -Title Insurance Premium Classifications (2014-06) – The working group adopted amendments to the disclosure requirements of SSAP 57 to delete the categories for Gross All Inclusive Premiums and Gross Risk Rate Premiums.

SSAP 104R Revisions (2014-17) – The working group adopted proposed revisions to SSAP 104R to integrate ASU 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period*. The guidance is effective January 1, 2016, with early adoption permitted.

2012 Group LTD Table and Health Actuarial Guideline XLVII (2014-21 and 2014-22) – The working group adopted revisions to incorporate changes to *Appendix A-010, Minimum Reserve Standard for Individual and Group Health Insurance Contracts* to require the use of the 2012 table, and the related Actuarial Guideline 47, *Application of Company Experience in the Calculation of Claim Reserves Under the 2012 Group Long-Term Disability Valuation Table*. At the request on an interested party, the effective date was moved a year later to January 1, 2017, with early adoption permitted.

ASU 2014-10, Development Stage Entities (2014-14)
The working group voted to reject this ASU as not applicable to statutory accounting.

Renaming of the SVO P&P Manual
During the December 12 conference call, the working group discussed the renaming of the Purposes and Procedures Manual of the NAIC Securities Valuation

Office to the Purposes and Procedures Manual of the NAIC Investment Analysis Office. NAIC staff proposed technical edits to update the publication's name in the 2015 version of the Accounting Practices and Procedures Manual. Changes will affect the Preamble, the investment SSAPs and other appendices. The name change will occur in all locations, except in Appendix A-785 Credit for Reinsurance as it reflects excerpts from a model law. NAIC staff proposed adding a drafting note in Appendix A-785 to reflect this. The proposal was adopted by the working group and subsequently, its parent task force.

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

Comments on exposed items are due to NAIC staff by January 16 unless otherwise noted.

Investment Classification Review (2013-36) – In 2013, the working group agreed to a new comprehensive project to review the investment SSAPs and clarify definitions, scope, accounting methods and reporting guidance. At the Fall National Meeting, recognizing that industry representatives have expressed serious concerns about the project since its inception, the chair of the working group asked for “concise” comments from interested parties on the prioritization of topics memo focusing on eight key issues that had been exposed for comment at the Summer National Meeting. An industry representative suggested that the working group “sharpen the focus of the project” and divide it into three work streams: 1) areas where clarification of guidance is needed; 2) investments or instruments where guidance regarding the classification or scope guidance is needed; and 3) areas where guidance may need to be amended.

After additional discussion, the chair directed NAIC staff to proceed with work on the first two issues discussed in the prioritization memo: 1) consider a definition for “security” within SSAP 26, taking into account the GAAP definition is already included in SSAP 37 on mortgage loans, and 2) consider a requirement for SSAP 26 investments to have a “contractual amount of principal due.” This issue proposes consideration of a new SSAP and investment schedule for all “funds” and reconsideration of the appropriate RBC based on the type and risk of fund. According to the prioritization memo, an assessment of “funds” is anticipated to include a “collective review for investments in open-end investment companies (mutual funds), closed-end investment companies, unit investment trusts, exchange traded funds, hedge funds, and investments in “trust funds” that do not currently fit

within the confines of SSAP 48 as an investment in joint venture, partnership or LLC.”

The chair also asked that mortgage loan participations included in SSAP 37 be added to the list of investments to be reviewed. Conference calls on the two priority issues discussed above are expected to be scheduled for January.

Single-Member and Single-Asset LLCs, Underlying Asset is Real Estate (2013-17) – In 2013, interested parties requested a change in accounting for real estate held by certain LLCs from SSAP 48 (valued using an equity method) to SSAP 40 (primarily valued at cost). This change would require appraisals for the real estate in accordance with SSAP 40, but the RBC charge is lower for Schedule A assets, and an audit of the LLC would no longer be required for admittance. The working group agreed with the proposal, but with specific criteria to qualify for such treatment, and exposed Issue Paper 149, Wholly Owned Single Real Estate Property in an LLC, on September 2.

At the Fall National Meeting, the working group adopted revisions to the Issue Paper including clarifying guidance that qualifying LLCs owned by a downstream holding company are not within scope of the guidance even when the downstream holding company is wholly-owned by the reporting entity. The working group then exposed the revised Issue Paper for comment along with revisions to SSAP 40 to adopt the guidance. The comment period ended December 8 and on its December 12 conference call, the working group adopted both documents after hearing a comment letter received from a trade organization in support of the proposal. Both documents were then adopted by the Accounting Practices and Procedures Task Force and Financial Condition Committee during the December 12 joint conference call. The guidance in SSAP 40R will be effective January 1, 2015 and cannot be early adopted. In addition, the guidance is not elective. All investments qualifying for real estate treatment shall be reclassified as such, starting with the first quarter of 2015.

XXX/AXXX Reinsurance Disclosure (2014-31) –The working group exposed for comment a proposed new disclosure related to the anticipated adoption of Actuarial Guideline 48 which would require the audited financial statements of insurers ceding XXX/AXXX “Covered Policies” (i.e. ceded on or after January 1, 2015) to disclose whether the Covered Policies are secured by funds consisting of Primary Securities and Other Securities and “if there are any deviations relative to the applicable standard, such deviations in quality shall be

disclosed and for quantitative deviations the amounts shall be disclosed.”

Statement of Cash Flows (2014-23) – At the Summer National Meeting, the working group asked for feedback from industry on non-cash items currently included in the statement of cash flows (as suggested by the cash flow worksheets included in the annual statement instructions). Comments from interested parties noted their belief that the intent of the cash flow statement is to include only cash items and that most companies exclude non-cash items and provide explanations for any cross checks errors. Accordingly, the working group directed staff to propose revisions to SSAP 69 to clarify that only items defined as cash, cash equivalents and short-term investments should be included in the statement of cash flows. In addition, disclosure of non-cash items affecting assets and liabilities will be expanded to include non-cash operating items in addition to financing and investing items.

On December 11, the working group exposed the changes to SSAP 69 discussed above with a January 16 comment deadline, noting that the proposed changes have been reclassified from substantive to nonsubstantive.

Medicare Advantage and Medicare Part D Adjustment Premium Receivables and Payables (2014-27) – NAIC staff has received questions as to the appropriate annual statement lines to report Medicare risk adjustment receivables and payables. Because increased amounts are expected to be reported for these balances as a result of the ACA, the working group asked for comments as to whether additional guidance should be provided in SSAP 54 related to these balances and whether additional guidance in general is necessary for Medicare Part D and Medicaid Advantage programs in addition to that provided by INT 05-05. At the Fall National Meeting, the working group directed NAIC staff to work with the industry to develop accounting and reporting guidance, including direction for the annual statement treatment. The working group also approved a referral to the Health Actuarial Task Force and Life Actuarial Task Force that the risk adjustment payable and receivables be included in the scope of the Actuarial Opinion.

ASU 2014-04 and ASU 2014-14, Receivables, Troubled Debt Restructuring by Creditors (2014-30) –The working group has proposed adoption in 2015 of these two recent ASUs with some modifications; the revisions provide guidance on accounting and disclosures for foreclosed mortgage loans. The modifications to ASU 2104-04 would broaden the scope to include all mortgage loan foreclosures and not just residential real estate with

a consumer mortgage loan. The ASU 2014-04 guidance is proposed to be modified to not allow a gain on foreclosure, which would require the real estate to be recorded at the lower of fair value or the outstanding mortgage loan balance.

FHLB Disclosures – The SAP Working Group heard a report from the Restricted Asset Subgroup regarding its analysis of the new FHLB disclosures that were filed for first and second quarters of 2014. The subgroup will review this information and “decide if further discussions to consider liquidity restrictions on FHLB activity are needed.” The report also noted that for a significant portion of companies FHLB activity is “minimal” in relation to assets or capital and surplus, but that some companies seem to have “excessive borrowing amounts” compared to assets and/or capital and surplus.

ASU 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects (2014-24)* – Proposed amendments to SSAP 93 were exposed for comment, which would adopt ASU 2014-01 with a significant modification: net income statement reporting would not be permitted. Entities would continue to report amortization of the investment cost down to residual value as a component of investment income and tax credits and other tax benefits as a decrease to income tax expense.

Asbestos and Environmental Exception Reporting (2011-45 and 2014-28) – In 2012, the working group adopted accounting guidance for SSAP 62R related to the Schedule F penalty for asbestos and pollution contracts that have duplicate coverage. However, the regulators are still struggling to finalize the guidance and instructions for Schedule F. At the Summer National Meeting, the working group exposed for comment two reporting options: option 1 is the current Blanks proposal and option 2 omits the original reinsurers detail from Schedule F. At the Fall National Meeting, the working group voted to expose option 1 over the objections of the interested parties who originally proposed the reporting. Option 1 also proposed revisions to the SSAP 62R guidance adopted in 2012.

Holder of Surplus Notes (2014-25) – At the Summer National Meeting, the working group asked for feedback as to whether paragraph 10 of SSAP 41 related to the valuation of surplus notes by the holders should be clarified. As part of that discussion, the working group asked for comments as to whether the thresholds used when applying a statement factor for valuation should be revised; the \$5 %/\$6 million thresholds have not been reviewed in 16 years. At the Fall National Meeting the working

group directed NAIC staff to draft revisions to clarify existing guidance around non-rated surplus notes and surplus notes with a designation below an NAIC 1. In addition, the working group confirmed that surplus notes with an NAIC 1 designation should be reported at amortized cost, without applying a lower of cost or outstanding face value standard; two-thirds of all surplus notes are rated NAIC 1. The working group also decided not to consider changes to the threshold statement factor at this time.

ASU 2014-15, *Presentation of Financial Statements-Going Concern (2014-29)* – The working group exposed for comment proposed changes to SSAP 1 and SSAP 4 to include disclosure in the audited financial statements of the evaluation of substantial doubt of an entity’s ability to continue as a going concern. The guidance would also amend SSAPs 48, 68 and 97 to nonadmit investments whose financial statements include going concern disclosures.

SSAP 11 Disclosures (ASU 2014-35) – The working group exposed proposed revisions to delete disclosures that pertain to defined benefit and defined contribution plans from the postemployment benefits guidance, with a reference to complete the disclosures in SSAP 92 if the entity is providing special or contractual termination benefits.

SSAP 25 Disclosures (2014-36) – The working group exposed for comment proposed revisions to reject ASU 2013-06, *Not-for-Profit Entities; Services Received from Personnel of an Affiliate* and to require disclosure of the fair value of services received or transferred by the insurance entity with an affiliated entity.

ASU 2014-16, *Derivatives and Hedging, Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share is More Akin to Debt or to Equity (2014-37)* – The working group exposed for comment a proposal to reject ASU 2014-16 as not applicable to statutory accounting because SSAP 86 does not bifurcate an embedded derivative from the host contract.

Principles-Based Reserving Implementation Task Force

The task force continued its accelerated pace, meeting six times since August to achieve the goal of adoption by year-end of Actuarial Guideline 48, *Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation (Model 830)*. This included an in-person

meeting in Washington D.C. on November 7 and convening at the Fall National Meeting.

XXX/AXXX Reinsurance Framework and AG 48

After adoption of the Supplemental XXX/AXXX Reinsurance Exhibit in September, effective for 2014 filings, the task force focused its work on finalizing AG 48, which had been drafted by the Life Actuarial Task Force together with Rector & Associates, with significant input from the ACLI. The task force released several exposure drafts of AG 48 in October and November and received comment letters from insurance departments, life insurers, the ACLI and the American Academy of Actuaries.

The result of this significant effort was adoption by the task force of AG 48 at the Fall National Meeting (with New York dissenting), and final adoption by Executive Committee and Plenary on December 16, effective January 1, 2015. During the discussion at Executive Committee, the representative from New York noted that although he would be voting “no,” for adoption, he noted that the proposal has a “great deal of merit, especially with respect to disclosure.” (Delaware also voted no and Minnesota abstained.)

The significant components of this eight page Actuarial Guideline include the following:

- AG 48 applies to “covered policies” (those required to be valued under Sections 6 or 7 of the NAIC *Valuation of Life Insurance Policies Model Regulation*) ceded January 1, 2015 and later. Policies already subject to a captive arrangement as of the end of 2014 would be grandfathered. However, policies ceded outside of a captive arrangement and policies not ceded prior to December 31 2014 would not be grandfathered. Guidance has been included to allow the ceding company’s domiciliary regulator, after consulting with the Financial Analysis Working Group, to exempt a transaction if such risks are “clearly outside the intent and purpose” of AG 48 or for other reasons specified in the guideline.
- “Primary Securities” must be used to fund the Actuarial Method reserves, which are calculated using VM-20 with specified modifications. Primary securities can include cash and SVO-listed securities meeting Section 3.B of the *Credit for Reinsurance Model Law*, excluding “any synthetic letter of credit, contingent note, credit-linked note or other similar security that operates in a manner similar to a letter of credit.” However, for reinsurance transactions subject to AG 48 which are funds-withheld and modified coinsurance arrangements, primary securities can also include highly rated

commercial mortgage loans, policy loans and derivatives “acquired in the normal course and used to support and hedge liabilities pertaining to the actual risks in the policies ceded pursuant to the reinsurance arrangement.”

- “Other security” used to fund reserves in excess of the Actuarial Method reserves can include any asset acceptable to the ceding company’s domiciliary state.
- Each reinsurance arrangement subject to AG 48 requires analysis by the appointed actuary on a treaty by treaty basis, and requires the appointed actuary to issue a qualified opinion if the requirements are not met.

The final step for uniform adoption of AG 48 by all the states in 2015 is inclusion of the actuarial guideline in the NAIC Accounting Practices and Procedures Manual, as that manual is adopted by all jurisdictions (subject to any state specific deviations). Discussion of adoption of AG 48 into the APP Manual by the SAP Working Group has not yet occurred at a public meeting.

Status of Other XXX/AXXX Reinsurance Framework Charges

The task force briefly reviewed a written report on the status of its charges to eight working groups and committees to implement the Framework. Open projects include the following (excluding those discussed in the Life RBC Working Group summary):

- The Life Actuarial Task Force will consider whether changes are needed to the *Actuarial Opinion and Memorandum Regulation* after adoption of revisions to the *Credit for Reinsurance Model Act and Regulation* and related Accreditation decisions.
- The Blanks Working Group is waiting for input from the PBR Implementation Task Force related to 2015 disclosures for XXX/AXXX transactions. Different disclosures may be considered for grandfathered transactions and those subject to AG 48.
- The Reinsurance Task Force established a drafting subgroup which is beginning work on an XXX/AXXX Model Regulation to establish requirements for the reinsurance of XXX/AXXX policies. Virginia is chairing the subgroup.

PBR Adoption by States

Since the Summer National Meeting, there have been no new states adopting the principles-based

reserving requirements; the current total of 18 states represents 28% of direct U.S. premium. Twelve additional states are expected to introduce legislation in 2015, which would bring the total to 60% of premium. The task force is still recommending the use of January 1, 2017 as the earliest probable PBR Valuation Manual effective date.

The task force then discussed what sections of the Standard Valuation Law must be adopted by states for consideration as “substantially similar” which will affect the Valuation Manual effective date. The task force voted to expose for comment until January 15 the same “substantially similar” components as were exposed for Accreditation purposes by F Committee in 2010 (but which has not yet been finalized).

Small Company Exemption

At the Fall National Meeting, the task force engaged in a heated discussion of LATF’s proposal for a small company exemption for PBR. LATF’s proposal is a “slightly modified” version of an exemption originally developed by the ACLI. New York strongly objected to the exemption, pointing out that PBR already has an exclusion test (stochastic and deterministic exclusion tests in section 6 of VM-20), and that there is no theoretical justification for exemption based on ordinary life premium levels. Another task force member countered that he has been told the cost to perform the exclusion tests is too high for a small company (as much as \$50,000), but Kansas stated that the cost figure is “vastly overstated.”

The task force then voted to expose the PBR Small Company Exemption Proposal for comment until January 15. After a regulator to regulator call on December 10, the ordinary life premium level to qualify for the exemption was adjusted downward to \$50 million for individual companies and \$300 million for a group of affiliated companies. (The ACLI proposal had recommended a \$300 million/\$600 million threshold.)

Capital Adequacy Task Force

The task force met at the Fall National Meeting and discussed the following projects.

Derivatives Proposal

In connection with the Investment RBC Working Group’s review of derivatives, that working group along with its interested parties group noted some technical issues with the current RBC formula and has suggested changes to the 2015 formula and instructions. The proposed change would exclude

cash collateral pledged for derivative transactions from a separate RBC charge and also proposes a new “centrally cleared” derivatives category for RBC and AVR (as a result of the Dodd Frank requirements), which would be assessed a 0.4% RBC charge. The intent of the proposal is for consistent reporting of cash pledged as collateral for derivative transactions. Comments on the proposal are due January 2.

Modification of RBC Requirement

At the Summer National Meeting, the task force was informed by NAIC staff that some companies have modified the RBC requirement amount for the calculation of Authorized Control Level when permitted by the domiciliary state. The task force reaffirmed that permitted practices are not allowed for RBC, and modified instructions on the task force’s webpage have been posted as “additional guidance” for 2014. At the Fall National Meeting, the task force exposed for comment until January 2 a proposal to add this guidance to the Management Discussion and Analysis section of the 2015 RBC Overview and Instructions.

Life Risk-Based Capital Working Group

The working group met via conference call October 17, November 3 and December 17 and in person at the Fall National Meeting.

XXX/AXXX Reinsurance Framework Referrals

The working group had been asked to consider three issues related to the Framework by the PBR Implementation Task Force which they discussed on both conference calls and drafted responses to the task force dated November 7.

RBC Cushion – The task force asked the working group to develop an RBC Cushion for insurers ceding XXX/AXXX business when the assuming company does not calculate NAIC RBC. The working group has suggested that for states that allow a captive to hold a lower RBC amount, the ceding insurer would need to hold any difference in its RBC calculation.

RBC for “Other Security” – The working group has been asked to develop charges for the “other security” under the Framework/AG 48. For “other security” which already has a C-1 charge, those factors will be used. For other assets, the working group has asked for input from the VOS Task Force.

Qualified Actuarial Opinion – The PBR Implementation Task Force asked the working group to “determine whether the current RBC C-3 treatment of qualified actuarial opinions is adequate for the purpose of the risks of XXX/AXXX

reinsurance transactions that receive qualified actuarial opinions.”

The working group discussed this issue at length during its conference calls and concluded that this proposal would have too broad of an effect and likely be disproportionate to the shortfall of high quality assets since the RBC treatment of a qualified opinion is to apply maximum RBC factors to all lines of business, just not those portions related to the XXX/AXXX reinsurance transactions.

At the Fall National Meeting, the ACLI commented that additional consideration of these recommendations is needed because of the complexities of these transactions. For example the proposed RBC Cushion solution assumes that the reinsurer is an affiliate of the ceding company but in some transactions, it is third party traditional reinsurer.

The working group continued this discussion during a conference call December 17 and exposed for comment until January 31 proposals for the qualified actuarial opinion and RBC charges for “other securities.” The exposed qualified opinion proposal reflects changes made since the Fall National Meeting to avoid impacting all lines of business for a qualification of the actuarial opinion based solely on lines of business covered by AG 48.

The deadline to adopt changes for 2015 RBC is April 30.

C-3 Phase II/AG43 (E/A) Subgroup Update

This joint subgroup is charged with evaluating the overall effectiveness of capital and reserve requirements for variable annuities and presenting recommendations to improve the effectiveness of those requirements. At the Summer National Meeting, the working group reviewed a letter from the subgroup asking for additional resources so that the necessary in-depth analysis can be performed. During the interim period, the subgroup chair discussed this request for resource assistance with the RBC working groups and LATF and the groups agreed that further detail of the project’s framework is needed. The chair of the subgroup (Ohio) will work with other regulators and industry experts informally to develop a project plan for the subgroup’s consideration. The chair of Life RBC noted that this approach reflects the importance of testing the potential effect of any proposed changes.

Stress Testing Subgroup

At the Fall National Meeting, the working group received an update from its subgroup. The intention of the subgroup is to have stress testing requirements in place when PBR becomes effective,

likely 2017. In light of this deadline, current discussions are mostly focused on the development of an appropriate stress testing framework. Recent discussions have addressed whether the eventual requirements should be at the legal entity level, consistent with most current statutory requirements, or at the group level, which is consistent with the International Association of Insurance Supervisors’ current development of a group-wide, global insurance capital standard. At this stage, the subgroup’s work has both options in mind.

Investment Risk-Based Capital Working Group

The Investment RBC Working Group met by conference call in September and October and in person at the Fall National Meeting.

Corporate Bond Factors

At the Summer National Meeting, the AAA presented updated base factors which expands the current 6 NAIC designations to 14 categories, utilizing “+” and “-” indicators to expand the number of designations for categories 1-4 (e.g., 1+, 1, 1-), but NAIC 6 and NAIC 5 designated bonds would not have +/- suffixes. The recommended factors are generally higher for investment grade bonds, and generally lower for below investment grade bonds, as compared to the current C-1 factors. On its October 24 conference call, the working group discussed feedback on the preliminary proposed corporate bond factors and modeling process received from the ACLI and several life insurers. The industry feedback focused on the need for the AAA’s corporate bond modeling documentation to include specific information, including:

- to what extent the changes in proposed C-1 factors are driven by updated experience in default and recovery rates versus by changes in the modeling methodology.
- sufficient explanations of the modeling approach, assumptions and the economic scenarios tested.
- how the representative portfolio was constructed.

The feedback also expressed concerns with applying the corporate bond factors to government and municipal bonds, noting that the S&P and Moody’s data used in the modeling did not include default and recovery data for sovereigns or municipals. These comments were in response to the working group’s informal request for comments. Once the AAA has completed its documentation supporting

its base factors, there will be a formal exposure period.

In Washington, the AAA reported that it still hopes to complete its documentation by the end of 2014, which is expected to include a reconciliation of the proposed factors to the current factors established in 1991 to identify the specific drivers of changes. The working group also discussed an ACLI letter which focused on the implementation challenges which would result from the proposed C-1 factors due to the expanded number of asset classes and the effect of the proposed significant increase to the risk factors for Aa, A and Baa bonds (current NAIC 2s) given the large concentration by life insurers in these categories. The ACLI also commented that this change could have unintended consequences by incentivizing revisions to asset and quality allocations. In response to this concern, NAIC staff supporting the working group noted that RBC is used to identify weakly capitalized companies; the C-1 factors reflect credit risk of securities and are not meant to incentivize companies or influence behavior.

Other Fixed Income Factors

The AAA's bond modeling has focused on the public corporate bond life C-1 factors. The working group also needs to determine how C-1 factors for non-modeled fixed income classes (municipal bonds, private placements, preferred stock, and other invested assets) should be developed. In Washington, the AAA reported that it has met with Moody's, and plans to meet with S&P, to discuss the ratings assigned by these CRPs to sovereign and municipal bonds. Moody's reported that its ratings for these bonds are assigned based on the expected loss, which is consistent with corporate bonds. The AAA believes they will obtain the same insight from S&P. Based on this, the AAA may recommend that the corporate bond C-1 factors also be applied to sovereign and municipal bonds.

Real Estate Factors

At the 2013 Fall National Meeting, the working group exposed for comment proposed changes to the RBC treatment of real estate; the most significant change is a proposed base factor of 8%, compared to the current base factor of 15% which has been in effect since 2000. Since that time, the working group has been waiting for feedback from the AAA which had commented that they had some questions on the proposal. During its September 19 conference call, the working group exposed for comment the AAA's detailed theoretical questions, such as what level of required capital is covered by the proposed factors, what risks are being covered and what time period was analyzed. The document also includes the working group's proposed responses. During its

October 24 conference call, the working group noted the questions did not result in changes to the proposed real estate factors, but are expected to enhance the documentation surrounding the proposal.

As discussed above, the initial proposal would reduce the current base factor of 15% to 8% for all real estate categories. While the recommended base factor was developed using a price variation analysis of what is perceived to be reliable real estate industry data, concerns have been expressed by the working group that the significance of the decrease in the base factor may incentivize insurance to increase their exposure to this less-liquid asset class. At the Summer National Meeting, the working group indicated that it would consider whether the base factor should be adjusted based on property types or geographic regions. In September, the working group reviewed real estate data disaggregated by region and property type. Based on review of the data, the working group reached a preliminary consensus that the base factor should be adjusted to reflect variable property type risk (beta factor). In particular, it was observed that hotels have greater price variability than other property types. A memo discussing the disaggregated real estate data was exposed for a 21-day comment period.

On its October 24 conference call, the working group noted that no comments were received on disaggregated real estate data. At the Fall National Meeting, the ACLI discussed their preference that the base factor be increased slightly rather than adding a beta factor. The working group plans to re-expose the real estate factor proposal once it has made a final determination as to the approach.

Life AVR Factors

In September, the AAA noted its support for the continuation of the Asset Valuation Reserve for life companies, and plans to update the AVR factors. The chair of the working group noted that the AVR factors will likely be considered at the Capital Adequacy Task Force rather than this working group.

Non-AVR RBC Considerations

In October, the working group reported that it had identified P/C and health insurance experts at the AAA that will assist in the analysis to develop and update their respective asset risk factors. The AAA representatives are familiarizing themselves with the corporate bond model developed for the life C-1 factors, and will consider whether that model can be applied to the P/C and health but using different assumptions or if new models will need to be developed. At its meeting in Washington, the working group heard a detailed presentation from a

recently retired member of the working group and a P/C actuary who reiterated his belief that the cost of adopting the proposed bond methodology for non-AVR companies would be greater than the benefits. He suggested retaining the current 6 class structure for non-AVR companies and reassessing those factors.

In response to this presentation and direction given by the Capital Adequacy Task Force, the working group will consider why asset risk does not have a significant impact on the RBC formulas for non-AVR companies. The working group plans to work with the P/C and Health RBC Working Groups to discuss and further analyze this, as on the surface one would expect these RBC calculations to be more responsive to changes in asset risk factors.

Timeline

The timeline for implementing any new life RBC C-1 factors remains uncertain given the significance of the work that remains. The 2016 life RBC calculation appears to be the earliest any changes could be implemented at this point; although based on industry comments the implementation of the expanded C-1 factors may require additional time to implement. The working group has not developed a formal work plan with specific target completion dates or deadlines to finalize its considerations.

Operational Risk Subgroup

The subgroup met frequently this fall via conference calls September through December pursuing its goal to develop and refine a risk sensitive operational risk charge by year-end 2017, effective for 2018. During the conference calls, the subgroup discussed the following topics.

Types and Examples of Operational Risks

The subgroup discussed seven types of Basel II operational risk banking events that are relevant to the insurance industry. The event types include internal fraud, external fraud, employment practices and workplace safety, clients, products and business practices, damage to physical assets, business disruption and system failures, execution, delivery and process management, and statutory and regulatory risk. It was noted that the Basel II categories have been adopted by a voluntary and primarily British database of insurance operational risk events called the Operational Risk Insurance Consortium (ORIC).

The subgroup also discussed an alternative risk categorization developed by the Joint Actuaries, which includes both U.S. and Canadian actuarial

groups. The chair commented that if the subgroup chooses to develop an operational risk database that would relate solely to insurance, it may want to consider the Joint Actuaries' categorization. The subgroup plans to continue its discussion on whether to develop a list tailored to insurance or adopt the Basel II list tailored to banking and used by ORIC and Solvency II.

Definition of Operational Risk

The subgroup continued to evaluate its working definition of operational risk and concluded that reputational risk would not be a part of RBC as its quantification would be difficult. The focus of defining operational risk should not be on developing taxonomy of causes but instead starting with taxonomy of events. It was further noted that by not including reputational risk within the definition of operational risk, most reputational risks can still be captured if it can be shown that they came from an operational failure.

The subgroup also discussed strategic risk which is the current or prospective impact on earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes. It was clarified that the focus is not on the strategy itself that was promulgated by the board or senior management but rather failures to implement that strategy. The chair commented that business risk within the Life RBC formula, which does not fall under the definition of operational risk, appears to be roughly equivalent to strategic risk. A trade organization representative commented that event risk and strategic risk would trip the trend test, which looks at unfavorable experience in the past year in the P/C RBC formula, which could imply that strategic risk is captured in the experience fluctuation and comparison to the industry average. The subgroup will continue discussing this matter in future calls.

Operational Risk Embedded in Existing Risk Charges

The subgroup discussed a chart listing the existing RBC risks for the purpose of identifying whether operational risk is embedded in those risks, and if so, can it be quantified in that current risk and can that risk be mitigated. Mapping of the current risk with the event list of risks to determine how some of the events may be embedded in existing risk charges is being performed by the NAIC staff.

Optional Partial Internal Model for the Operational Risk Charge

The subgroup discussed whether it would consider a partial internal model for determining the operational risk charge. The chair noted that Solvency II has a standard factor-based model that

allows companies to determine the use of a partial internal model. The internal models would be informed through the use of an operational risk database that would help with establishing factors in addition to providing input for partial internal models. If the subgroup agrees to pursue this method, the Basel II Banking Method of Producing an Operational Risk Internal Model framework could be used as a starting point. The first step of the framework involves using the company's ORSA to identify a set of operational risk scenarios. The second step is exploring the scenarios with experts in order to build a risk library or matrix, assess the frequency of loss under each scenario, and applying expert judgment to estimate the most common loss severities and worst-case scenarios. The information from the first two steps is used to derive a loss distribution for each scenario. The next step is to assess the correlations between the scenarios and the final step involves the use of copula, a probability theory, to aggregate the various scenarios into an operational risk charge.

No action was taken by the subgroup on the partial internal model; however, the subgroup will continue to discuss the pros and cons to developing an operational risk database. Reasons supporting development include providing statistical basis for revising factors in the factor-based operational risk charge, increasing understanding and awareness of operational risk for both insurers and regulators, and providing a statistical basis for an optional partial internal model. Reasons opposing are that it is an additional reporting requirement for insurers and that the reliability and usefulness of the database is dependent on the quality and quantity of operational risk loss reporting. The subgroup agreed that if they were to proceed with the database that it would need to be compulsory for all insurers.

Operational Risk Testing

The subgroup received an update from NAIC staff on the status of internal testing noting that the staff will begin testing operational risk factors using data from 2013 filings. There are two methodologies for developing capital requirements for operational risk from the data included in the 2014 RBC on an informational-only basis. The first methodology is a proxy-based approach that includes two elements, a basic operational risk component that will compare a factor applied to net direct or written premium to a similar factor applied to net claim or loss reserves and a growth operational risk component that will be assessed based on the year-over-year increase in gross direct or written premium. Both elements will be combined to derive an operational risk charge.

The second methodology replaces the basic operational risk component with a capital add-on

approach that will apply a risk factor to RBC after covariance (without operational risk). This alternative basic operational risk charge would be combined with the growth risk charge calculated under the proxy method to derive an operational risk charge.

NAIC staff reported that data for P/C and health companies would be compared for companies that triggered a growth risk charge under the existing methodologies in the two RBCs to determine if more or fewer companies and different companies will trigger a growth charge. The base charge method used for testing involves picking factors between 1% and 5% for the capital add-on approach for each RBC formula and then distributing factors in the proxy approach to achieve an overall similar result, noting that the capital add-on approach is calculated after covariance and the proxy approach is before covariance. This method will be used for testing 2013 and 2014 data subject to input from the subgroup.

Property/Casualty Risk-Based Capital Working Group

The working group met by conference call on October 22 and in Washington to discuss the following projects in process.

Reinsurance Credit Risk Charge (R3) Proposal

On October 22, the working group discussed comments received on RAA's revised proposal for the R3 charge. The AAA expressed support for the proposal, but reiterated its concern that the revision does not address the issue of excessive use of reinsurance. The RAA responded that adding an additional element for excessive use of reinsurance would significantly complicate the proposed framework; however, if the working group wishes to pursue this, an additional charge could be added to R3 or placed elsewhere in the RBC formula. A working group member commented that it supports the R3 credit risk charge as it links to the creditworthiness of the reinsurer and believes that the same rationale should apply to the contingent credit risk elements in R6 and R7. The RAA responded that it agrees from a theoretical perspective, but that practical limitations would prevent the application of reinsurer-specific ratings-based approach to modeled reinsurance recoverable balances. Following the discussion, the working group agreed to refer the issue of the contingent credit risk for R6 and R7 to the Catastrophe Risk Subgroup.

In Washington, the working group discussed that under the current proposal, unrated authorized domestic reinsurers could potentially have higher

credit risk charge than the collateralized offshore reinsurers. The working group discussed reasons why reinsurers make an election not to be rated, including cost considerations. Following the discussion, the working group re-exposed the proposal after adding a column to identify authorized unrated reinsurers with factors of 5% for collateralized and 10% for uncollateralized for a comment period ending December 17.

Investment Affiliates

Per the RBC instructions, the RBC charge for the ownership of an investment affiliate is based on the RBC of the underlying assets and prorated for the degree of ownership. The basis for this calculation is the assumption that the charge should be the same as it would be if the P/C insurer held the assets directly. Because investment affiliates do not submit RBC filings, the RBC charge for the investment affiliate cannot be easily determined and is therefore difficult to verify. In order to address this challenge, the working group discussed simplifying the RBC charge for the ownership of investment affiliates by using a fixed factor times the carrying value of the common stock, preferred stock and bonds. Following the discussion, the working group exposed the simplified RBC charge proposal for a public comment period ending December 31.

Because the proposal will alter the charge applied to entities defined as investment affiliates which other insurance entities may own, the working group submitted a memo to the Capital Adequacy Task Force discussing this issue. At its meeting, the task force voted to refer the issue to the Life and Health RBC Working Groups for their consideration.

ACA Risk Adjustment and Risk Corridor Tests

The working group discussed the ACA risk adjustment and risk corridor test proposal for 2015 noting that a new page PRO26 would add a sensitivity test to reduce the total adjusted capital by either the receivable or payable for the ACA risk adjustment and risk corridor based on a misestimation factor of 25% over and under. The proposal will allow for analysis of the impact of the ACA risk adjustment and risk corridor receivables and payables on total adjusted capital. The test does not change a company's RBC amounts reported in the annual statement. The working group exposed the proposal for a comment period ending December 31. This is the same sensitivity test that was adopted for the Health RBC formula for 2014.

Underwriting Risk – Experience Fluctuation Risk Proposal

The working group discussed a proposal to add a new blank page PRO20A Underwriting Risk – Experience Fluctuation Risk and instructions for

2015 that breaks out premiums, claims and the medical loss ratio by individual, small group and large group plans as well as a break out of claims and MLR for Medicare, Medicaid and other health business. The changes will allow for analysis of the impact of the ACA on health business written by the P/C insurers and is consistent with the RBC reporting adopted for the Health formula for 2014. The proposal is for informational use only and will not impact the company's actual RBC. The working group exposed the proposal for a comment period ending December 31. The importance of gathering this data from all entities providing health insurance was discussed at the meeting of the Capital Adequacy Task Force since this data will be used to update the underwriting factors.

Catastrophe Risk Subgroup

The subgroup met by conference call on October 10, November 3 and December 8 and met at the Fall National Meeting to discuss the following:

Calculation of R6 and R7

The subgroup discussed comments received on an industry proposal previously exposed for calculating the R6 (earthquake) and R7 (hurricane) charges. The proposal asserts that there can be different interpretations of the PRO25 instructions related to the calculation of the catastrophe risk charge. The proposal illustrates two methods that are commonly used but which result in vastly different amounts. Refer to the PwC NAIC Summer 2013 Newsletter for more information on the two methods. Seven comment letters were received and the subgroup heard that insurers should be allowed to utilize methods which are consistent with their own internal catastrophe risk management process.

The working group also heard a “theoretically correct approach” raised by a trade organization. The NAIC instructions specify that data must be provided for the worst year in 50, 100, 250, and 500 years; however, only the worst year in 100 is used in the calculation of the catastrophe risk charge. The theoretically correct risk charge calculation within the current framework bases the catastrophe charge on the worst simulated year in 100, with the “worst” defined as having the highest value of the sum of its two components, the net loss component and the credit risk component. The charge is then calculated as the sum of these two components for the worst simulated year thus defined. Since the total risk charge consists of two elements - the net loss charge component, and the component associated with the risk that ceded reinsurance amounts may be uncollectable - both of the risks should be considered together, within the same scenario, and the scenario

corresponding to the chosen safety margin should then be chosen. In this case, the safety margin is based on the worst year in 100 calibration level. During the December 8 conference call, the subgroup discussed the long-term solution which is to specify the measurement criteria preference and explore the option of the “theoretically correct approach” as it may improve the accuracy of the calculation, while the short-term solution is to allow companies to use the methodology that is consistent with their own enterprise risk management processes or Own Risk Solvency Assessment methodology. The subgroup will conduct an e-vote to expose a new attestation for 2015 that companies will complete to disclose the methodology used.

R6 and R7 Contingent Credit Risk Proposal

In connection with RAA’s reinsurance credit risk charge proposal discussed in the P/C RBC Working Group summary, the RAA is proposing to use the same factor for R6 and R7 as that used for the uncollateralized factor for Secure 3 rated reinsurers in R3, which is 4.8%. This is based on the fact that catastrophe reinsurance is mostly placed with Secure 2 and 3 rated reinsurers. Four comment letters were received noting the charge should take into consideration the credit quality of the reinsurers and historical default rates. Some subgroup members expressed support for a single-charge approach while the chair suggested exploring a long-term solution to vary the contingent credit risk charge according to the creditworthiness of the reinsurers.

A few subgroup members raised a concern that varying the contingent credit risk charge would introduce additional complexity to the R6 and R7 charges. RAA noted that practical limitations would prevent the application of a reinsurer-specific ratings-based approach to model reinsurance recoverable balances but suggested performing a quantitative analysis to look at how ceding companies in catastrophe-prone areas report their potential catastrophe losses and associated contingent credit risk in the information-only phase of RBC reporting which will provide the subgroup a better perspective on the appropriateness of the contingent credit risk factor. During the December 8 conference call, the subgroup exposed a proposal to revise the catastrophe contingent credit risk charge for modeled reinsurance recoverable in R6 and R7 from 10% to 4.8% for a comment period ending January 30.

2014 Catastrophe Events List

In an effort to maintain a current list of events whose losses should be excluded from the determination of underwriting risk charges R4 and R5, the subgroup

discussed and exposed the 2014 Catastrophe Events List for possible inclusion in the list. The 2014 events were derived using Aon Benfield published data and listed events are based on estimated economic losses of \$25 million or greater. During its December 8 conference call, the subgroup adopted the proposal.

Catastrophe Risk Charge Exemption

The subgroup discussed a proposal previously raised by industry over a year ago that would exempt certain insurers from the catastrophe risk charge requirements. The proposal was not adopted because further consideration of the exemption criteria was needed. The subgroup requested industry input and in Washington discussed an updated proposal that would exempt companies under the following circumstances:

- if the insurer satisfies the 0% net exposure standard included in the RBC instructions
- if the insurer writes less than a defined amount of total property insured value
- if the insurer writes total property insured value that includes hurricane and/or earthquake coverage in catastrophe-prone areas representing less than a defined percentage of its surplus as regards policyholders

Industry believes the above-mentioned criteria are an improvement when compared to use of direct written premium in the previous proposal. During the December 8 conference call, the subgroup reviewed proposed changes to page PR026 incorporating the exemption criteria above and exposed the proposal for a comment period ending January 30.

Aggregate Exceedance Probability vs. Occurrence Exceedance Probability

The subgroup discussed an industry concern previously raised with respect to using an AEP curve versus using an OEP curve to model catastrophe losses. The concern was raised prior to the 2013 RBC filings and the subgroup, at that time, determined to continue to require the R6 and R7 charges to be calculated using an AEP approach. The concern was raised again and it was noted that most rating agencies use an OEP approach as it is more practical to apply to a modeled loss exposure that is net of reinsurance. Based on a 2013 study by Aon Benfield which analyzed public catastrophe risk disclosures from 96 insurers and reinsurers, 70% used the OEP approach. The subgroup will continue its discussion of this issue on future calls.

Health Risk-Based Capital Working Group

The working group met by conference call on October 17 and December 8 and in Washington and discussed the following issues.

ACA Risk Adjustment and Risk Corridor Tests

On October 7, the working group discussed the ACA risk adjustment and risk corridor test proposal for 2015 that was exposed at the Summer National Meeting. Comments were received from a trade organization noting if there is a liability and asset, they are likely to come from different markets or different states and therefore, may not offset one another. As such, the recommendation is for the underestimation test to use the sum of the two values rather than the net of the two values. The chair reminded companies that the proposal is primarily a formatting change when compared to 2014 whereby a new page XRO23 is being added for the test. There are no proposed changes to the factors or calculations. The working group will consider the recommendation to change the calculation after it has had an opportunity to analyze the results of the original sensitivity test. Following the discussion, the working group adopted the proposal.

Medicare Advantage MLR Proposal

The working group discussed comments received on the previously exposed Medicare Advantage MLR proposal which would add two new lines, Line (12) Title XVIII-Medicare Net Incurred Claims and Line (19) Title XVIII-Medicare Underwriting Risk Claims Ratio, to the Underwriting Risk section of the 2015 RBC filing. The changes are the result of the implementation of the new MLR requirements for the Medicare Advantage Program and the Medicare Prescription Drug Benefit Program established under the Affordable Care Act. One comment letter was received from a trade organization which recommended the addition of a new line (13) Other Health Net Incurred Claims. This would allow incurred claims that do not fall into any of the defined categories to be reported, such as Medicaid incurred claims. The working group agreed with the recommendation and exposed the revised proposal through November 4. In Washington, the working group heard that no comments were received and adopted the proposal with editorial revisions.

Excessive Growth Charge Proposal

The working group discussed comments received on the exposed excessive growth charge proposal. The intent of the proposal is to add clarifying language for start-up companies to use projected amounts in the prior year amounts in the excessive growth

charge calculation. The issue is if a start-up company does not have a full year of operation in its first year and there is a significant variation in the relative risk amounts to the premium for the partial year of operation, a company could still encounter an excessive growth charge because the RBC formula is based on a calendar year. The chair commented that the issue is not just the definition but the time period of excessive growth.

During its December 8 conference call, the working group discussed comments received including those from a retired regulator from the Connecticut Insurance Department. The Connecticut letter included a detailed analysis which noted that generally only 6% to 8% of reporting companies have an excessive growth charge greater than zero. After additional analysis of those companies, the comment letter concludes that the excessive growth charge has not been a significant factor in causing a company (start-up or otherwise) to be subject to regulatory consequences.

Also on December 8, the working group heard that the Operational Risk Subgroup is looking into the excessive growth charge in connection with internal testing the NAIC staff is performing using 2013 data. The working group agreed for NAIC staff to work with retired Connecticut actuary and the Operational Risk Subgroup on this issue.

Investment Risk

NAIC staff reported that the Investment RBC Working Group is working on several items that may impact the working group. One item is the basic question of impact of different RBC charges and how they affect the RBC ratios of non-asset valuation reserve (AVR) companies. The Investment RBC Working Group plans to coordinate several conference calls with the non-AVR RBC working groups to discuss the appropriateness of the impact, along with the analysis and documentation of the rationale for the determination. The working group was informed that the preliminary results of the analysis of the corporate bond factors for life companies resulted in higher expected factors for "A" and "BBB" rated bonds and this could have an impact on health companies.

An industry concern was raised that the model used in the development of the factors was based on life assumptions and those assumptions are not appropriate for health insurers. NAIC staff reported that discussions have been held with AAA to develop a representative portfolio for health.

Medicaid Pass-Through Payments

During the December 8 conference call, the working group discussed Medicaid pass-through payments

and how each state handles these payments. The working group reviewed a draft survey to states to gather information and did an outreach seeking additional survey questions to be sent to NAIC staff by January 9. The draft survey will then be discussed and exposed for comment during an interim call scheduled for January 13.

Valuation of Securities Task Force

The task force held three conference calls in September and October and met in Washington, taking the following actions.

Adopted Amendments to P&P Manual

The task force has adopted the following amendments to the Purposes and Procedures Manual of the NAIC Investment Analysis Office since the Summer National Meeting.

NAIC Bank List – At the Summer National Meeting, the task force exposed a proposal to equalize both the long term debt (Baa/BBB) and short term debt (P2/A2) credit rating thresholds for foreign and domestic banks on the Bank List contained in the P&P Manual. The proposal also recommended lowering the required threshold of sovereign credit ratings to AA or better for long-term debt, and P1/A1 or better for short-term debt. The task force also referred the proposed changes to the Bank List criteria to the Reinsurance Task Force, as the list was established to facilitate reinsurance admissibility. The referral also asks the Reinsurance Task Force to consider whether the Bank List should be expanded to include financial institutions more broadly, to be consistent with the terminology used in the Credit for Reinsurance Model Law.

In September, the Reinsurance Task Force responded to the referral, stating that nothing about the reinsurance process or its regulation by the states suggests a reason why foreign banks should be required to meet a higher credit rating standard than domestic banks. Further, the task force commented that the definition of qualified U.S. financial institutions in the reinsurance models was intended to be broader than banks. The task force recommended that the VOS Task Force consider amending to the P&P Manual so that the SVO maintains a list of qualified U.S. financial institutions, if it finds after studying the issue that such institutions would be at least as experienced and well regulated as banks.

At the Fall National Meeting the task force adopted the proposed changes to the P&P Manual, as previously exposed, to equalize the credit rating thresholds for foreign and domestic banks and to lower the required sovereign credit ratings. The task force directed the SVO to study the regulation of other financial institutions in comparison to the regulation of banks to address the comment provided by the Reinsurance Task Force.

Data Quality Requirements – The Securitization Data Quality Working Group held two interim conference calls in September to finalize the documentation standards for the annual modeling of Re-REMIC securities. At the Fall National Meeting, the task force adopted the proposed documentation standards effective for the December 31, 2014 publication of the P&P Manual. Having completed its charges, the task force voted to disband the working group.

Catastrophe-Linked Bonds – The task force adopted an amendment to the P&P Manual to provide guidance for catastrophe-linked bonds that are not assigned a credit rating by a credit rating provider. The amendment reflects the SVO recommendation to use the special reporting instructions referred to as 5*/6* in these cases. No comment letters were received on the proposal during the exposure period.

Clarify Application of NAIC Designations – The task force adopted an amendment to the P&P Manual to clarify guidance that NAIC designations are assigned to specific issuer obligations and reflect the credit risk associated with that specific issue, and do not reflect the issuer's general senior unsecured credit quality rating. No comments were received on the proposal during the exposure period.

CRP Credit Ratings Eligible for FE – In October, the task force discussed comments received on a proposed amendment to clarify the CRP credit ratings characteristics required to qualify for conversion to an NAIC designation under the filing exempt (FE) process. The comment letters noted that the requirement that the rating assigned to the issue be “continuously monitored” by the CRP could be misinterpreted. The task force and interested parties agreed that the security be monitored at least annually. Interested parties also commented that limiting the security identifiers to CUSIP, private placement number or CUSIP International Number System is too restrictive. The task force members agreed to modify this provision to require that a CRP rating must be assigned to a specific security that can be specifically identified. Following this discussion, the chair of the task force requested that the proposal be updated to include the modified

language and be redistributed. The task force reviewed and adopted the revised proposal at the Fall National Meeting.

Private Rating Letters

At the Summer National Meeting, the task force discussed an SVO project that initially identified approximately 5,700 securities designated by insurers as FE, but for which the SVO was not able to confirm with its data sources that the filing exempt classification was appropriate. The SVO attributed these discrepancies as likely the result of private letter ratings obtained from CRPs by insurers. The SVO proposed that insurers file copies of all private letter ratings with the SVO when the security is not in NAIC systems. Industry strongly objected to this proposal and agreed to work with the SVO to develop a compromise solution.

In October, the SVO reported that most of the discrepancies were actually attributable to other FE issues, not necessarily private letter rulings, including CDs, pre-refunded securities and lottery securities. For approximately 2,700 securities (\$95 billion), the SVO has not yet identified the reason for the FE discrepancy. The SVO will continue to work with the industry to determine the cause and develop a solution. At least one CRP has indicated that it plans to file all private letter ratings with the SVO on a go forward basis, despite there being no official requirement to do so.

2014 RMBS & CMBS Modeling Timeline

On September 17, the task force exposed the assumptions for the 2014 financial modeling of RMBS and CMBS for a brief comment period. While the assumptions have been updated to reflect current market conditions, there were no changes in methodology, scenarios or weightings. On its October 2 conference call, the task force discussed interested party comments on the modeling assumptions. ACLI commented that the modeling assumptions should not change from year-to-year unless significant market changes occur. The SSG staff agreed that maintaining a standard set of economic assumptions for future modeling should be considered; this change would require a policy change by the task force and could not be implemented for the 2014 modeling. Following the discussion, the task force approved the modeling assumptions as exposed.

SEC Changes to Money Market Fund Rules

At the Fall National Meeting, the task force discussed an SVO report regarding the impact of changes to money market fund (MMF) rules which were adopted by the SEC in July. The changes will reverse an exception granted to institutional prime

MMFs which permitted the use of a stable net asset value (NAV) of \$1.00 per share. The rule changes are subject to a two-year transition period, and will become effective on October 14, 2016.

A stable NAV is a requirement for bond classification of MMFs on the NAIC US Direct Obligations/Full Faith and Credit List and the Class 1 List. MMFs on the Class 1 List, for which the structure is not modified, would transition to a floating NAV and come off the list in 2016. Government MMFs are not affected by the rule changes and will continue to use a stable NAV. The NAIC U.S. Direct Obligation/Full Faith and Credit Exempt List is consistent with the SEC definition of Government MMFs. The SVO has concluded that no immediate action is necessary, given the two-year transition period and because the SAP Working Group's investment classification project will reconsider the appropriateness of the MMF bond classification. The SVO report was exposed for a comment period ending January 16.

NAIC Designation Recalibration

As the Investment RBC Working Group continues to consider whether NAIC designations should be expanded for RBC and AVR purposes (referred to as Recalibration), NAIC staff continues to consider the impact that such a change would have on NAIC operations and procedures. In conjunction with this effort, during the 2013 Fall National Meeting, the SVO noted a lack of uniformity in terminology and the existence of inappropriate references in certain state insurance investment-related laws. At the 2014 Fall National Meeting, the task force voted to refer a previously exposed SVO technical document to the Financial Regulation Standards and Accreditation Committee. The SVO document provides guidance on how best to refer to NAIC designations and related processes in state laws based on existing NAIC model laws. The intent of the referral is to solicit input from the committee as to how best to promote uniformity in NAIC designation terminology across the states, and not to develop an accreditation standard. The task force believes that the impact of Recalibration on state laws would be minimized if states had an opportunity to align references to NAIC designations in state investment laws to the NAIC's current and anticipated usage before the Recalibration project is finalized.

Non-U.S. GAAP Considerations

On its September 11 conference call, the task force exposed separate position papers to permit the SVO to use financial information presented in accordance with Canada's Accounting Standards for Private Enterprises and French GAAP to conduct credit

analysis comparable to that performed using financial information presented in accordance with U.S. GAAP or IFRS. On October 2, the task force exposed a proposal containing related changes to the P&P Manual, which was adopted at the Fall National Meeting. This will allow an insurer to file audited financial statements prepared on these accounting bases with the SVO when it submits securities from issuers that do not prepare GAAP or IFRS financial statements for SVO consideration. For financial statements prepared on a French GAAP basis, additional documentation is required for the SVO to conduct the credit analysis, including a consolidated statement of cash flows for three years and disclosure information for leases and pension obligations.

In Washington, the ACLI informed the task force that the United Kingdom accounting standards have been significantly modified; the changes are effective in 2015. These changes will require an amendment to instructions in the P&P Manual that currently permit the use of UK national GAAP without reconciliation to U.S. GAAP. The SVO will study the changes in the UK accounting standards and to make recommendations to the task force.

Derivative Instrument Model Regulation

In Washington, the task force discussed a report from the SVO regarding a request from the Financial Condition (E) Committee to review the *Derivative Instruments Model Regulation* against the NAIC's Model Law criteria and consider whether the model should be retained, amended, converted to a guideline or archived. The SVO report notes that since the most recent revision by the NAIC in 2009, only one state has adopted the revised model. Nine other states have adopted some other legislation related to the regulation of derivative instruments, including the pre-2009 model law. Despite these low adoption rates, the SVO believes that derivative regulation is an important issue on which the NAIC should have a position. The SVO recommends that the task force evaluate changes that have occurred since 2007 in federal laws and regulation governing derivatives, insurers' current use of derivatives, and changes in the current marketplace before responding to the referral from E Committee. The task force exposed the SVO report for a comment period ending February 15.

Catastrophe-Linked Bonds Regulatory Framework

The task force received a presentation from the North American CRO Council (NACROC), which requests a review of the regulatory framework that applies to catastrophe-linked bonds. The NACROC

representative stated that the C-1 (credit risk) factor of the life RBC formula creates an RBC charge that is disproportionate to the risks of this asset class. Catastrophe-linked bonds, which are not commonly rated by a CRP, are subject to the 5*/6* treatment, receiving the highest C-1 charge despite having very little credit risk. As a result life insurers do not typically participate in the catastrophe bond market.

NACROC suggested that the life RBC formula should instead view these bonds based on the more significant risk, as insurance, and apply a C-2 insurance risk factor. P&C insurers would benefit from this change by providing access to additional capital base, leading to better pricing. Life insurers would benefit from the portfolio diversification and obtain a higher risk-adjusted return. The task force noted that the Capital Adequacy Task Force would be a more appropriate place for this proposal, but agreed to expose the presentation for a comment period ending January 16.

Corporate Governance Working Group

The working group conducted an e-vote on October 9 to expose for comment a memo recommending that the newly adopted *Corporate Governance Annual Disclosure Model Act* and the *Corporate Governance Annual Disclosure Model Regulation* be considered Part A Accreditation Standards. The working group also exposed for comment a recommendation that the revisions to the *Annual Financial Reporting Model Regulation* relating to internal audit requirements for large insurers also be considered a Part A Accreditation Standard.

The working group received two comment letters from Florida and the joint interested party trade groups. Consistent with the debate surrounding the adoption of the corporate governance models, Florida raised concerns that the proposed confidentiality standard appears to exceed the scope of the Accreditation Program Manual, and therefore suggested revision to the proposed wording. Interested parties again raised concerns that states might adopt "compromised or weakened" confidentiality provisions and proposed edits to the exposed language. The chair noted the wording as proposed is consistent with other standards based on her discussion with NAIC legal counsel, and the working group adopted both recommendations as exposed for consideration by the Financial Regulation Standards and Accreditation Committee.

Having accomplished its charges, the working group disbanded after its meeting in Washington.

Group Solvency Issues Working Group

During six conference calls between the Summer and Fall National Meetings, and in Washington D.C., the working group discussed proposed revisions to the *Insurance Holding Company System Regulatory Act* (#440), and specifically the criteria involved in the ability to act as a group-wide supervisor for internationally active insurance groups. The revisions also outline the process for determining the lead state for domestic insurance groups, summarize the activities the commissioner may perform as group-wide supervisor, and extends confidentiality protections to cover information received in the course of group-wide supervision.

Industry representatives were very active in the process, providing comments on proposed revisions, with particular focus on the requirements to designate a group-wide supervisor. Views were mixed as to whether the group-wide supervisor criteria should be the lead state criteria, unadjusted from current guidance, or a tiered lead state criteria approach, focusing on those criteria relative to financial strength. Regardless of the approach chosen, there was collective support that there should not be more than one group-wide supervisor.

Three industry groups support an unadjusted lead state criteria in determining the group-wide supervisor; their representatives are most concerned with the possibility of having a different group-wide supervisor and lead state, and the potential complications associated with it. In contrast, ACLI and AIA, which would have more companies subject to the requirements, support the tiering approach to remove subjectivity in some of the lead state criteria. They asked to focus on those criteria relating to financial strength, rather than all criteria having equal importance.

The working group continued discussion on a subsequent conference call on December 3. Ultimately the unadjusted lead state criteria for determining the group-wide supervisor was adopted, as many regulators and insurers are comfortable with the current lead state criteria. In addition, proposed revisions were adopted to make it clear only a single lead state could exist, and to add a “catch all provision” to allow the commissioner the authority to perform other activities, not specifically outlined in the Act, but consistent with the purpose of their role as the group-wide supervisor.

The revisions to #440 were also adopted by the Executive Committee and Plenary during their December 16 conference call. During the December

16 meeting, the chair of the Executive Committee noted that these revisions are an important step forward for U.S.-based regulation and “reduces the chances that the Federal Reserve or the FIO will step into our shoes as regulators.”

Key definitions adopted by the NAIC include the following:

- “Group-wide supervisor” - The regulatory official authorized to engage in conducting and coordinating group-wide supervision activities who is determined or acknowledged by the commissioner to have sufficient significant contacts with the internationally active insurance group.
- “Internationally active insurance group” - An insurance holding company system that (1) includes an insurer registered under Section 4 [of the Insurance Holding Company Model Act]; and (2) meets the following criteria: (a) premiums written in at least three countries, (b) the percentage of gross premiums written outside the United States is at least 10% of the insurance holding company system’s total gross written premiums, and (c) based on a three-year rolling average, the total assets of the insurance holding company system are at least fifty billion dollars or the total gross written premiums of the insurance holding company system are at least ten billion dollars.

The definition of IAIG is intended to be consistent with the ComFrame definition.

Private Equity Issues Working Group

The working group met via conference call on October 23, and discussed comments received from Athene Holding Ltd., which suggested edits to the proposed Financial Analysis Handbook guidance on suggested best practices for regulators to consider in their review of potential acquisitions of life insurers by private equity companies and hedge fund managers. Athene’s comments were generally supported by the regulators during the call. Most of the discussion centered on whether there should be a minimum RBC requirement over a three to five year period. Ultimately, the language was removed as several regulators noted that such limitations should be negotiated between the entity and the regulator.

During the Fall National Meeting, the working group received a presentation from Igor Rozenblit, Head of the Private Funds Unit at the SEC, which provided his insight into the private equity market’s

investments in insurance companies. He discussed that there are various techniques which private equity funds utilize when investing in insurers. The venture capital approach typically maintains funds within the entity to assist in its growth. Alternatively, leveraged buy-outs typically pull excess cash from the entity, which is either replaced by debt, supported by operational improvements, or the entity is held for sale. Some of the advantages of private equity investment include an increase in capital in the entity, strong asset management and a focus on increased profitability. Some of the risks of private equity investment include the potential for lower capitalization, use of “near-related party transactions” to maximize its assets, which are challenging to regulate, and a potential decrease in service levels.

Based on the SEC presentation and the October conference calls edits to the current draft of the Financial Analysis Handbook, the chair asked the working group to consider through January 15 whether any additional changes to the Handbook are necessary. Subsequently, the revisions will be exposed for a 45-day comment period.

International Insurance Relations Committee

IAIS Process Reforms

The committee heard an update from its vice chair Commissioner McCarty (FL) regarding the IAIS’ efforts to improve efficiency, including evaluating or eliminating existing groups in the IAIS. As part of the IAIS procedural changes, Commissioner McCarty noted that the NAIC commented on one proposed change to close meetings to stakeholders. This discussion has been ongoing for months, and many interested parties as well as regulators voiced their concern over the lack of transparency. During the Fall National Meeting, the committee reiterated its position that the closed meeting policy is a step in the wrong direction, and stated it plans to provide similar comments when the second draft is exposed.

Financial Sector Assessment Program (FSAP)

The chair updated the committee on the voluntary assessment under FSAP which is performed every five years. For the insurance sector, the program includes a self-assessment of U.S. compliance with the 26 IAIS Insurance Core Principles (ICPs). The 213 page self-assessment, coordinated between the NAIC, FIO and Federal Reserve, is available on the NAIC’s website. The IMF is now preparing its Detailed Assessment Report of the insurance sector, which is expected to be completed in the next few months. Since the U.S.’s last assessment in 2009, the NAIC has adopted an ORSA requirement and an

insurance-specific corporate governance filing requirement, both of which were identified as suggested improvements in the 2009 assessment.

Congressional Testimony

On November 18, the chair of the committee, Commissioner Consedine (PA) testified on behalf of the NAIC to Congress, in a hearing entitled, “The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers.” His discussion included the importance of transparency at the IAIS, capital standards, and the global regulatory environment impacting U.S. multi-national insurers. He expressed the NAIC’s commitment to working with domestic lawmakers in furthering the discussion with international regulatory bodies, including the IAIS and the FSB.

ComFrame Development and Analysis Working Group

ComFrame

The working group received an update on the field testing of the IAIS’ ComFrame process which is unchanged from the Summer National Meeting. Module 1 quantitative testing is underway though early 2015, and subsequent iterations of field testing will be conducted in the second quarter of 2015 through 2018. Module 2, qualitative field testing, began in October 2014, focusing on group structure and corporate governance.

It was noted during the ComFrame meeting that the Group Solvency Issues Working Group is working on revisions to the Holding Company Act related to the authority of a U.S. regulator to act as group-wide supervisor. The GSI Working Group has asked the ComFrame group to resolve whether a supervisor should have the discretion to designate a group as an Internationally Active Insurance Group, even if the IAIG criteria are not met. The GSI Working Group ultimately adopted revisions to the Holding Company Act during its December 3 conference call, noting that when the NAIC’s ComFrame group concludes on the item, the regulators can make additional revisions to the Holding Company Act, rather than delaying the group-wide supervisor guidance.

International Capital Standard

The working group heard an update on the field testing process of the IAIS’s proposed International Capital Standard, which is on a very compressed timeline. The components of the capital standard include the Basic Capital Requirement (BCR) and a Higher Loss Absorbency (HLA) requirement. The IAIS’s ICS consultation paper was released December 17 for a 60 day comment period and is

available on the IAIS's website. Development of the ICS is proposed to be completed by the end of 2016 with implementation in 2019.

Development of a Domestic Group Capital Standard

During the Summer National Meeting, interested parties were asked to submit proposals on a group capital standard to which nine submissions were received. In a call leading to the Fall National Meeting, the chair asked NAIC staff to narrow the recommendations down to one or two high-level proposals for discussion. These recommendations were summarized in a U.S. Group Capital Methodology Concepts Discussion Paper which proposes two primary approaches to be explored: an "RBC Plus" methodology and a Cash Flow/Stress Test methodology, or a hybrid approach of the two.

As outlined in the discussion paper, the RBC Plus approach, which would be a group RBC calculation based on consolidated U.S. GAAP financial statements, has several advantages including being a familiar framework to U.S. insurance regulators with factor based calculation, and being verifiable and auditable. By comparison, the advantages of the Cash Flow/Stress Test include being accounting independent; it inherently encompasses asset/liability modeling, utilizing similar modeling as PBR, and is segmentation independent.

Reactions by interested parties were mixed to the potential standards. An interested party commented that working group needs to be clear which companies a group capital standard would apply to, i.e. just IAIGs or other insurance groups as well. Non-life interested parties noted that the cash flow test is more difficult for P&C companies as the processes have yet to be developed. A suggestion was made that there should potentially be two models, differentiating between life and non-life entities. A suggestion was made that an RBC Plus approach should just be used as a floor. Similarly, there should be a baseline calibration to the ICS.

Life industry representatives appreciated the cash flow approach being devoid of accounting convention, particularly in the global insurance market with various reporting jurisdictions. In addition, this approach is easier to react to changes in the market and products.

NAIC staff is continuing to evaluate the approaches and asked for comments from the working group and interested parties by December 5.

Financial Stability Task Force

The chair opened the meeting with an update of the current developments of the IAIS. The 2014 designation of global insurers designated as G-SIIs by the IAIS was completed in November. Nine insurers, three domestic (AIG, MetLife and Prudential Financial), have been given this designation.

The task force also received an update on the Financial Stability Board's policy proposal to enhance the total loss-absorbing capacity (TLAC) of global systemically important banks (G-SIBs). The proposal, which was issued in November and is currently exposed for comment through February 2015, is expected to double the minimal capital amount required for G-SIBs. The IAIS is currently exploring whether TLAC should be an appropriate measure for G-SIIs as well.

Reinsurance Task Force

The task force met via conference call in October and in person at the Fall National Meeting to discuss the following projects.

Report of Qualified Jurisdiction Working Group

During the Summer National Meeting, the working group reported that they are performing seven full reviews of supervisory authorities, and announced that five jurisdictions have been approved: Bermuda, Germany, the UK, France and Ireland. (These regulators were previously accepted as conditionally approved qualified jurisdictions at year-end 2013.) The remaining two jurisdictions, Switzerland and Japan, were still being reviewed at the time of the Fall National Meeting, but were completed in December; all seven jurisdictions were approved during the Executive Committee and Plenary meeting December 16. As a result of this process, these seven countries will be included on the qualified jurisdiction listing as of January 1, 2015; the designation is valid for five years, after which time the jurisdictions will need to be re-evaluated.

Report of Reinsurance FAWG

The working group shared the current draft of the Uniform Application Checklist for Certified Reinsurers, which states use during the process of certifying reinsurers. The draft includes amendments based on comment letter feedback received through early November. The working group received nine comments, mostly pertaining to the requirement of providing a listing and description of reinsurance recoverable balances in dispute when the amounts exceed 1% of net reinsurance recoverables. The comment letters noted

this may be an administrative burden for insurers, and during the Fall National Meeting, interested parties suggested raising that threshold.

During its December 11 conference call, the task force heard an update that the FAWG had met in a regulator-to-regulator session on December 3 to discuss revisions to the proposed checklist based on comments heard in Washington. The FAWG chair noted that the checklist has been revised “dramatically” to soften the language on certain requirements. During the conference call, the task force heard concerns on the key issue discussed in Washington relating to reinsurance recoverable balances in dispute. In order to move the checklist to adoption, the FAWG chair made a request for industry to collaborate as a united front and submit a joint comment letter. The FAWG chair also agreed to conduct an open call with industry in January to discuss the joint comment letter and possible revisions.

The Reinsurance Task then adopted the Uniform Application Checklist during its December 11 meeting, which was also adopted by the Financial Condition Committee December 12.

Reinsurance Modernization Implementation

The task force received an update on the adoption of the revised credit for reinsurance models by the states, noting that 23 states have adopted the models, which represents more than 60% of U.S. direct premium. Five additional states have confirmed that they plan to adopt the models in 2015, which would bring the total to 80% of U.S. premiums. With respect to the certification of reinsurers, the chair reported that 30 reinsurers have now been certified by eight states to hold reduced collateral, and additional reinsurers are being currently reviewed. Twenty-six of these certified reinsurers have been reviewed and “passport” by the Reinsurance Financial Analysis Working Group.

The RAA asked the task force to consider revision of its accreditation requirements for states to adopt the models to certify reinsurers. The task force had previously concluded that the 2010 revisions to the Credit for Reinsurance Models related to certified reinsurers are optional and should not be required for accreditation since the revisions are considered by the task force to be less stringent than the earlier credit for reinsurance models. The RAA noted that uniformity on this topic is critical to the industry. For example, if one state has not recognized the revised models, and a pool participant is domiciled in that state, then the pool would need to fully collateralize. The co-chair suggested that the task force recommend to the Financial Regulation

Standards and Accreditation Committee that the 2010 revisions to the Credit for Reinsurance models be considered a requirement for accreditation.

SVO Listed Securities

During its conference call on October 29, the task force discussed at length its joint project with the VOS Task Force to evaluate the objective of a clause in the *Credit for Reinsurance Model Law*, which states that security for the payment of a reinsurance obligation could take “the form of... securities listed by the Securities Valuation Office.” (The issue arose in connection of what assets should be permitted as “Primary Securities” for purposes of AG 48; see the PBR Implementation Task Force summary for that discussion.) A research memo dated July 10 by Bob Carcano (SVO Senior Counsel) concluded that the purpose of the clause was to refer to the listing of securities published by the SVO in the NAIC Automated Valuation Service Plus online subscription. In preparing an exposure draft distributed for public comment, certain revisions to the research memo were made for industry to consider, such as adding specificity in terms of certain securities that should be included or excluded.

Four comment letters were received, raising questions on the liquidity of certain investments, the use of private placements, affiliated investment transactions, and whether “bespoke” securities (custom securities, often affiliated) should be removed from the SVO list, which is the view of several regulators including the chair of the VOS Task Force. Following discussion on these topics, the task force requested the SVO to prepare a report that would 1) discuss the SVO compilation process of sub-lists used to create the NAIC Automated Valuation Service Plus online subscription, and evaluate the risk of bespoke investments that may exist within it; 2) evaluate how the NAIC might distinguish between SVO listed securities and bespoke securities; and 3) formalize the structure to allow the NAIC to lend its expertise to states. As of the date of this publication, a report by the SVO covering these topics has not yet been released.

Blanks Working Group

Supplemental Reinsurance Exhibits

The working group held a conference call on September 19 to discuss a previously exposed proposal to add a new Supplemental XXX/AXXX Reinsurance Exhibit to the Life and Fraternal annual statement blank (2014-18BWG). At the Summer National Meeting, the ACLI cited concerns with the 2014 effective date given that the disclosure refers to an actuarial guideline that not yet been adopted by

the NAIC. The working group agreed to extend the exposure for the proposal until September 16 and requested that ACLI work with the PBR Implementation Task Force to agree on a compromise disclosure for 2014 year-end reporting. The revised proposal included an exemption for year-end 2014 to disclosing the “Required Level of Primary Reserve” and “Primary Security Adjustment.” The amended proposal was adopted by both the PBR Implementation Task Force and the Blanks Working Group in September.

The Supplement requires four new schedules to be filed by April 1, 2015:

- Part 1-All XXX and AXXX Cessions,
- Part 2-Transactions Subject to Part 2 Disclosure, which applies to all cessions except those ceded to licensed, accredited, or certified reinsurers or the reinsurer maintains a trust fund,
- Part 3-Collateral for all XXX/AXXX Reinsurance Transactions Reported on Part 2, and
- Part 4-Non-Collateral Assets Supporting Reserves for All Affiliate XXX/AXXX Reinsurance Transactions Reported on Part 2.

Other Blanks Working Group Activities

In Washington, the working group adopted guidance for 2014 annual reporting that Medicare Advantage Part C and Medicare Part D standalone business should continue to be reported in the “Government Business (Excluded by Statute)” column of the Supplemental Health Care Exhibit despite the fact that these coverages are no longer “excluded by statute.” The original blanks proposal would have required separate reporting of these plans in the Supplemental Health Care Exhibit based on HHS rules that were adopted as final in June 2013 which impose an 85% medical loss ratio on these plans. The change in the proposed 2014 reporting guidance was made in response to interested parties concerns regarding the challenges to implement system changes to accurately capture this data given the guidance was being considered so late in the reporting year. Interested parties have agreed to work towards reporting of this data separately in the Supplemental Health Care Exhibit for the 2015 data year.

The working group also exposed a Corporate Governance Working Group memo requesting a review of possible reporting redundancies between the Corporate Governance annual filing and the annual statement filing. A consumer representative noted that removing perceived redundancies from the annual statement filing would reduce

transparency as the annual corporate governance filings will be made on a confidential basis. The comment deadline for exposed items is February 27.

Investment Reporting Subgroup

The subgroup held two conference calls following the Summer National Meeting, focusing principally on the review of Schedule BA to determine whether the thirty-plus categories can be reduced to 9. Interest parties strongly cautioned the subgroup that changes to Schedule BA will impact the automated data pulls into the AVR and RBC calculations which have been developed by software vendors. The subgroup intends to remain aware of the desire to maintain the capability to direct pull information into the AVR and RBC schedules, where possible. The subgroup directed NAIC staff to prepare an annotated proposal of the Schedule BA instructions showing the collapsed categories. The subgroup met on December 9 to review the staff proposal; following spirited discussion, the subgroup concluded that additional clarifications to the category definitions are needed before the proposal can be advanced due to confusion related to what categories should or should not be combined and condensed.

The subgroup has previously discussed whether collateral loans should be reported on Schedule BA; however no conclusions have been reached. This consideration has been deferred pending the SAP Working Group’s consideration of collateral loans as part of the investment classification review project.

The subgroup also discussed the lack of consistency among insurers of the security descriptions reported on the investment schedules. The subgroup would like to develop some level of uniformity on prospective holdings, but does not intend to require insurers to adjust the description of existing holdings. The subgroup is considering a blanks proposal which would suggest four different vendor sources (Bloomberg, IDC, Thomson Reuters, and S&P/CUSIP) that could be used to obtain security descriptions, but likely would not make the sources mandatory. The subgroup would also like to capture information regarding each securities structure, which would enable examiners to more easily identify holdings of higher risk. This might require additional columns to be added to the Schedule BA electronic submission. Alternatively, SVO staff commented that the NAIC may be able to obtain capital structure information based on the security identifier. This information could then be made available to regulators via an NAIC database.

Further consideration is needed with respect to these approaches.

The subgroup's next conference call has been scheduled for January 13.

Navigating Interest Rate Risk in the Life Insurance Industry

Following the last session of the Fall National Meeting, the NAIC Center for Insurance Policy and Research (CIPR) hosted a panel discussion of Navigating Interest Rate Risk in the Life Insurance Industry. The panelists, both industry and regulatory participants, provided insight into various topics and the resulting impact to life insurers, including forecasting upcoming interest rate changes, the impact of sudden spikes in interest rates, as well as the continued prolonged low interest rate environment, and the impact to both product mix and investment yield.

Based on analysis of the annual statement submissions of over 700 life insurers, the CIPR provided a summary that illustrated during the period of 2006 through 2013, the average net portfolio yield declined 0.8%, while the average guaranteed credited rate declined 0.25%, resulting in a reduction in spread of 0.55% on average. The panel discussion concluded with each panelist expressing the importance of ERM, investment management, and chief executives' within the life insurance industry evaluating the various possibilities of the direction of interest rates and anticipating the potential effects on their companies.

Unclaimed Life Insurance Benefits Working Group

The working group held a conference call on September 17 to consider recommending to the Life Insurance and Annuities Committee that a new NAIC model law be developed to address the issue of unclaimed death benefits, a project the working group has been considering for almost a year. During the conference call, the working group unanimously voted to make this recommendation, which was adopted by its parent committee, and by Executive Committee and Plenary at the Fall National Meeting.

Per the Request for Model Law Development adopted in Washington, the proposed title of the new model law is the Unclaimed Life Insurance Benefits Act, and the Act would "require all authorized

insurers regulated by the state's insurance department to undertake good faith efforts, as to be specified in the Act, to locate and pay beneficiaries' proceeds under unclaimed life insurance policies, annuity contracts, and retained asset accounts issued in the state or remit such proceeds as unclaimed property to the appropriate jurisdiction if the beneficiaries are unable to be located or paid." The model development has not yet been assigned to a working group or committee.

As part of its recommendation, the working group also approved sending a comment letter to the Uniform Law Commission's Drafting Committee to Revise the Uniform Unclaimed Property Act (which is part of the National Commission on Uniform State Law) to inform the Committee of its recommendation to develop a NAIC model and to ask that the Committee not revise the *Uniform Unclaimed Property Act* because it would create the dual regulation of life insurers. That letter has not yet been finalized.

Life Actuarial Task Force

During the day and a half dedicated to the LATF meeting the lengthiest discussion and the most well attended was an update regarding development of an actuarial guideline for Indexed Universal Life Illustrations. This topic and other highlights from discussions since the Summer National Meeting are summarized below.

PBR Valuation Manual and Related Matters Valuation Manual Amendments

During interim conference calls LATF voted to re-expose and then subsequently adopted the ACLI Small Company Exemption proposal. This amendment exempts from stochastic and deterministic testing "small companies" (defined below) where any ULSG business is "non-material ULSG" business. The intent of this exemption is to reduce the amount of work small companies must do, assuming the types of products sold by most small companies would not be expected to develop a deterministic or stochastic reserve in excess of the net premium reserve. The concept of a non-material secondary guarantee on UL business is intended to minimize the need to calculate stochastic and deterministic reserves for products expected to operate primarily on the base guarantee.

The amendment defines a small company as measured by ordinary life premium volume, RBC ratio and the absence of universal life products with secondary guarantees that do not meet the definition of a non-material secondary guarantee. Statements

of exemption must be filed with the company's domestic commissioner by July 1 of the reporting year and may be rejected by the Commissioner. The amendment also clarifies the basis for calculating basic and alternative minimum reserves under the exemption. The proposal was later revised by the PBR Implementation Task Force using a threshold of ordinary premiums of \$50 million or less for individual companies and \$300 million or less for affiliated groups with a comment deadline of January 15.

At the Fall National Meeting LATF discussed and exposed for comment the recommended VM-20 current and long term investment spread tables that were developed based on the framework adopted at the Summer National Meeting. Under this framework, separate spreads are provided for investment costs and default costs; default costs will be updated annually while investment spread costs will be updated quarterly. The period ending September 30, 2014 is the first period for which the NAIC has calculated the spreads independently based on source data from vendors J.P. Morgan and Bank of America; historically the American Academy of Actuaries has developed the tables and the last update was as of December 31, 2013. Combining data from two vendors is expected to minimize variation in results. The spread tables were exposed for comment until December 2.

LATF also adopted changes to VM-20 to revise the Stochastic Exclusion Ratio Test (SERT), increasing the threshold for exclusion from 4.5% to 6.0%, to help eliminate "false negative" situations where products fail the SERT but the minimum reserve is not the stochastic reserve. The adopted changes also include language clarifying the use of a company's Asset Adequacy Analysis models for this purpose.

XXX/AXXX Reinsurance Framework and AG 48
See the PBR Implementation Task Force summary for discussion of this topic.

Indexed UL Illustration Guidance

IUL products are not included in the current *Illustration Model Regulation*; regulators and some industry representatives are concerned that a few companies are illustrating these products with overly favorable investment returns. The task force heard statements from regulators, the ACLI (in support of the draft guideline they proposed) and the "Coalition" of companies supporting an alternative guideline to that proposed by the ACLI.

During the lengthy discussion in Washington, LATF members, ACLI representatives, "Coalition" company representatives and other interested parties continued their ongoing discussion of a proposed actuarial guideline for application of the *Life Insurance Illustrations Model Regulation* to indexed universal life (IUL) contract illustrations. The LATF chair opened the discussion noting that the task force must quickly develop and adopt a guideline for NAIC adoption at the 2015 Spring National Meeting in order to impact illustrations effective July 1, 2015.

The first draft of a proposed guideline, written by ACLI, was exposed after the Spring National Meeting; some ACLI member companies opposed to the guideline (i.e. the Coalition) voiced their concerns at the Summer National Meeting and provided an alternative guideline during the interim period. Revisions to the ACLI draft guideline as well as the Coalition alternative guideline were exposed for comment in September. Representatives from these two groups have presented the key aspects of their respective proposals.

The ACLI draft guideline focuses on crediting rates used in the illustrations and resulting impacts on policy values, while the Coalition guideline focuses on the investment return assumption for the derivative instruments supporting the indexed account portfolio and requires weighting this with general account yield to determine the investment return assumption underlying the disciplined current scale. The Coalition companies' concern is that current IUL illustrations hurt the competitiveness of fixed UL products because the focus is the crediting rate, and the illustrations mask differences inherent in the general accounts that support the credited rates.

During the exposure period LATF asked the ACLI and the Coalition to respond to specific questions regarding their individual proposals, and to six general IUL illustration questions. The responses to these questions were discussed at this session. Comments on the exposed guidelines were submitted by regulators in California, Iowa and New York, and thirteen interested parties. Some of these comments are addressed below.

LATF members identified guiding principles for a compromise proposal and asked the ACLI and the Coalition to work jointly on a new proposal that would accomplish the following:

- 1) results in maximum IUL credited rates no more than 1.25% to 2.25% higher than traditional UL credited rates;
- 2) includes a prominent, side-by-side midpoint illustration with credited rates lower than traditional UL;
- 3) considers Ted Chang's closed-form solution methods and the use of stochastic simulation (Ted Chang is a California DOI actuary who provided a technical paper commenting on the two proposals);
- 4) minimizes the chances of loopholes or other undesirable consequences;
- 5) caps the illustrated credited rate on policy loans to the rate being charged on policy loans as shown in the illustration; and
- 6) strengthens the Illustration Actuary's role in establishing the method for IUL illustrations.

A conference call was scheduled for December 11 to continue the discussion, but has been deferred until January; a specific date for the call has not yet been set. LATF requested that the ACLI and Coalition submit comments on the above working proposal and a comprehensive list of issues and improvements that need to be addressed.

Actuarial Certification

LATF (and HATF and CASTF as well) received a report from the Academy President Mary Miller regarding the attestation form and database being developed to facilitate actuaries' certification of their qualifications for issuing any Statement of Actuarial Opinion. The draft form is the same for life, health and property/casualty opinions and the database would be voluntarily populated with the completed form and supporting documents. The form allows members to identify how each element of the U.S. Qualification Standards (USQS) was met, will help members understand and comply with the requirements, and will also increase public knowledge of the USQS. The Academy is still considering comments received this fall, and a revised draft will be exposed for comment; no date for exposure was discussed.

Actuarial Guideline XXXIII (AG 33)

During the interim period LATF discussed comments on proposed changes to AG 33 to address the application of incidence rates in valuing elective components of non-elective non-mortality benefits.

The proposed changes clarify the definitions of elective and non-elective benefits that are mortality-based and other than mortality-based. The proposed changes also clarify assumptions that are expected to underlie the incidence rates for non-elective benefits other than mortality-based benefits. LATF will continue work on changes to the proposed language during the interim period, targeting implementation by year-end 2015.

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. The proposed methodology sets the reserve equal to the greater of a "Floor Reserve" and a "Modeled Reserve," where the floor reserve is expected to generate results comparable to current CARVM requirements while the modeled reserve is scenario-based. The modeled reserve is predicated on identification of key risk drivers and uses the "representative scenarios method" (RSM) to generate scenarios for each key risk and assign probability weights to each scenario. Challenges include limited historical experience on which to base probability weights, and the absence of guidance and constraints on the scenarios. The Kansas Field Test is being conducted to test the feasibility of the RSM approach, and results so far appear logical; higher reserves emerge under scenarios reflecting greater risk. Next steps included completion of the Kansas Field Test, finalizing the modeled reserve framework and proposing an initial draft of VM-22 to LATF. No timeframe was provided for completion of these tasks.

Valuation Mortality Tables

LATF received a report from the Society of Actuaries & Academy Joint Project Oversight Group on the status of work related to development of a 2014 Valuation Basic Table (VBT). Following the Summer National Meeting the 2014 VBT Primary tables were exposed for comment. One comment letter was received and those comments will be addressed in the final report or within the tables. The Relative Risk tables which reflect the range of expected mortality from super preferred to residual standard risk are targeted for exposure before the end of the year, along with a new Underwriting Criteria Scoring Tool. A considerable amount of time was spent discussing development of the 2014 CSO Preferred Structure tables and the margin structure, as well as the notion of projecting mortality improvement to 2017 (vs. 2014) so that the mortality rates coincide with the expected PBR effective date. LATF guidance is for margins to cover 70%-79% of claims

experience from contributing companies, and this equates to a margin of approximately 15%.

LATF also discussed the application of credibility to determine PBR margins for use in VM-20 deterministic and stochastic reserves. LATF requested that the Joint Project Oversight Group provide a recommendation regarding the application of mortality improvement to 2017. A conference call will be scheduled in January to discuss credibility and PBR margins. NAIC adoption of the 2014 VBT and CSO tables is targeted for summer 2015.

Generally Recognized Expense Table

At the Summer National Meeting LATF voted to expose the 2015 GRET factors developed by the SOA Committee on Life Insurance Company Expenses. The proposed factors reflect simplified categorization of distribution modes as compared to that used to generate the factors in prior studies, as well as the use of a single set of unit expense seeds (relativities that implicitly allocate expenses between (non-commission) acquisition and maintenance expenses) across all distribution channels, reflecting the current level and structure of unit expenses in the marketplace. The resulting expense factors were notably different than those in prior years, and comments from the ACLI requested that LATF consider a transition period because of the material changes.

LATF members noted that the new methodology is an improvement and during an interim call voted to adopt the 2015 GRET factors without a transition period. The 2015 GRET factors were also adopted as final by the Executive Committee and Plenary at the Fall National Meeting.

Indexed-Linked Variable Annuity Subgroup

This subgroup is charged with providing recommendations to LATF regarding the applicability of the NAIC variable annuity regulatory framework to separate account index-linked products filed as variable annuities (ILVAs). During the interim period, the subgroup held one open call to discuss this matter and a brief update was provided at this meeting. The interim call focused on comparing the risks and rewards in ILVAs to other insurance products. The subgroup wants to develop a uniform framework for consumers to compare risks for this product between companies and/or other products. Work on this framework will continue.

Synthetic GIC Model Regulation

The Deposit Fund Subgroup of the Academy Annuity Reserves Work Group presented proposed revisions to the *Synthetic Guaranteed Investment Contracts Model Regulation* (#695) to address a mismatch between asset and liability valuations with these products which creates unnecessary volatility in statutory financial results, particularly in low interest environments. Changes were initially recommended to LATF in November 2012 and the current proposal reflects additional changes to address feedback received over the past two years and LATF's requests to expand the proposal to include Synthetic GICs issued to pooled funds. The proposed changes include the original changes to the valuation discount rate (to a 50/50 blend of Treasury spot rates and corporate bond index), elimination of the AVR factor-based deduction in the reserve in cases where the default risk is borne by the policyholder, and additional changes specific to pooled fund contracts to expand the Plan of Operations requirements, clarify and strengthen valuation requirements, and to expand the actuarial memorandum requirements related to withdrawal risks. Comments are due on the proposal by January 16.

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.

At the Fall National Meeting, the working group adopted the exposed AG 38 interpretation permitting the delinking of liability cash flows and asset net investment returns in calculating the gross premium reserve, provided the actuary can demonstrate that the impact of such delinkage on the reserve calculation is consistent with the applicable AG 38 and VM-20 requirements. This interpretation clarifies guidance in VM-20 Section 7.C.4 requiring consistency between projected levels of non-guaranteed elements (i.e. UL credited rates) in the cash flow model and experience assumptions used in AG 38 Section 8D reserve determination.

The working group also voted in Washington to re-expose an interpretation related to the applicability of Section 8D to reinsurance assumed and the use of hypothetical portfolios for testing the gross reserves. Subsequent to the meeting, comments on the exposed interpretation were discussed and the

interpretation was modified further and re-exposed. The proposed interpretation directs that Section 8D does apply to reinsurance assumed on risks in scope, and provides guidance regarding use of hypothetical portfolios for testing AG 38-8D business ceded under a direct coinsurance arrangement. Under AG 38 Section 8D, insurers must hold reserves no less than the deterministic reserve level computed under VM-20 with an adjustment to the investment earnings, reinvestment earnings and the resulting investment earned rates as defined in AG 38 Section 8D. VM-20 investment earnings are limited to the lesser of the actual portfolio earnings or a hypothetical A-rated portfolio under AG 38 Section 8D.

The exposed interpretation allows a company that cedes business under a coinsurance agreement to coordinate with and make use of the reserve calculations of the assuming reinsurer for purposes of meeting the hypothetical portfolio definition. However the ceding company, in calculating the pre-reinsurance ceded reserve or gross reserve required by AG 38 Section 8D, must assure that such modeling and assumptions are appropriate as provided by VM-20 Section 8.D.2. The interpretation was exposed through December 10. The working group will continue work on an interpretation related to the interest rate and other factors reflected in the determination of the shadow account value used in establishing the denominator of the pre-funding ratio as defined in AG 38 Sections 8B, 8C and 8E.

PBR Review Working Group

The working group was formed to coordinate financial analysis, examination, and actuarial review procedures related to PBR. The working group met at the Fall National Meeting and heard updates from its subgroups on various projects.

PBR Blanks Reporting Subgroup

The subgroup held a November 3 conference call to discuss comment letters from two states and two life insurers with respect to the proposed changes to the annual statement and instructions to adopt PBR that had been exposed at the Summer National Meeting. The 24 page document included proposed changes to the Analysis of Increase in Reserves (in both the general and separate account), Exhibit 5, the Five-Year Historical Data and the five part PBR VM-20 Supplement. The subgroup stated that it intends to incorporate many of the suggestions into the next draft and re-expose in early 2015. This exposure

identified the need to define what constitutes a “change in valuation basis” in a PBR valuation from a prior reporting period as a fundamental issue. The working group voted to refer to the Life Actuarial Task Force and the SAP Working Group to determine what constitutes a change in valuation basis under SSAP 51 for principle-based reserving.

PBR Review Procedures Subgroup

The subgroup met five times in closed conference calls during the interim period to continue “brainstorming” on potential review procedures and development of tools for analysis and examination of PBR. The subgroup has developed guidance for the Financial Analysts Handbook, the Financial Condition Examiners Handbook and the confidential financial profile report. Proposed new procedures relate to the PBR actuarial report required in VM-31 (Reporting and Documentation Requirements for PBR). The subgroup expects to share the developed guidance with the working group by the Spring National Meeting.

NAIC Support for PBR Reviews

The working group discussed NAIC support for PBR reviews and the Valuation Analysis Working Group (VAWG) process. NAIC resources plan to support state insurance departments with the review of PBR reports, which will help provide consistency given the degree of judgment involved. The VAWG will work with the Life Actuarial Task Force in interpreting the Valuation Manual.

Reporting Framework

NAIC staff provided an update on their draft revised Company Experience Reporting Framework (formerly known as the Statistical Agent Framework) under VM-50 and VM-51, which incorporates many interested party and regulator comments during the exposure period. The revised draft will be presented at the Commissioner’s Roundtable to make sure the draft framework does not conflict with existing state laws related to confidentiality and expense sharing. Upon the commissioners’ approval, the revised framework will be referred to the PBR Implementation Task Force for further exposure.

PBR Company Outreach

The working group heard a status report on PBR Company Outreach. The PBR Implementation Task Force worked with Society of Actuaries to conduct a survey to determine companies’ preparedness for PBR. Data was provided by 53 companies. The Society of Actuaries is resolving inconsistencies in the data with hopes for publishing the final results shortly.

Health Actuarial Task Force

Long-Term Care

The Society of Actuaries reported progress on its study of LTC claims terminations, incidence and utilization. The study covers exposures in years 2000-2011 and the goal of the study is to develop experience-based tables that reflect a variety of differences in policyholder and benefit characteristics. The research group also plans to develop a database of LTC experience data to facilitate user access of specific data for individual company modeling needs and analysis. The experience tables are targeted for completion in March 2015.

The LTC Actuarial Working Group received a report from the Long Term Care Pricing Subgroup on development of an assumptions template to accompany actuarial memorandums supporting initial product filings and rate increase filings. The template is intended to help regulators compare filings and gain a sense for how aggressive or conservative the pricing is. The information collected in the template includes the basis for actuarial assumptions, claims costs, selection factors, incidence rates, continuance factors, as well as mortality rates and morbidity rates. Considering the information requested, confidentiality also needs to be considered, particularly with filings through the NAIC's System for Electronic Rate and Form Filing (SERFF). The template was developed through discussions on closed calls during the interim period.

The LTC Actuarial Working Group also received a report from the Long Term Care Valuation Subgroup on discussions related to the adequacy of premium deficiency reserves. Discussion during an interim conference call and in Washington related to a survey conducted by the California Department of Insurance to gather information on assumptions used in evaluating the need for premium deficiency reserves. The results indicate that discount rate and rate increase assumptions were more aggressive than regulators expected, and as a result there is concern among regulators about the adequacy of active life reserves. Concern about LTC reserves generally is elevated due to recent announcement from one carrier that their claim reserves would be significantly increased. No formal recommendations were made at this meeting, but the subgroup will continue discussion of this topic, including the potential for establishing additional requirements regarding premium deficiency reserves and corresponding assumptions.

Individual Disability Income

The Academy's Individual Disability Table Work Group provided a progress report on the development of updated individual morbidity tables. Proposed tables were exposed for comment through June 30, and the work group has modified the proposed tables in response to comments. During the interim period HATF established the Individual Disability Valuation Table Implementation Subgroup to expose the final version of the 2013 Individual Disability Income Valuation Table, as well as oversee adding references in the table to the *Health Insurance Reserves Model Regulation (#10)*, developing an actuarial guideline to implement use of the table and methodologies for its use, and collaborating with the SAP Working Group to add references to the table in the Accounting Practices and Procedures Manual.

Other Matters

In other matters HATF also discussed a letter from the SAP Working Group expressing concern over the optionality permitted in the proposed effective dates in recently issued/exposed guidance relating to adoption of long term disability tables (2012 Group Long-Term Disability Valuation Table and 2013 Individual Long-Term Disability Income Valuation Table). The concern is that the optionality will hinder regulators' ability to evaluate and compare reporting entities on a consistent basis. This issue was resolved by the SAP Working Group at the Fall National Meeting by deferring the effective date to January 1, 2017 (with early adoption permitted) and eliminating the optionality.

Contingent Deferred Annuity Working Group

The CDA Working Group met via conference call on October 24 and October 31 and at the Fall National Meeting to continue its consideration of several projects with respect to the regulation of contingent deferred annuities. As adopted for 2014 and subsequent reporting, the NAIC defines a CDA as "an annuity contract that establishes a life insurer's obligation to make periodic payments for the annuitant's lifetime at the time designated investments, which are not owned or held by the insurer, are depleted to a contractually defined amount due to contractually permitted withdrawals, market performance, fees and/or other charges." This results investment risk and longevity risk being transferred to the insurer.

On its October calls, the working group discussed a revised draft of the guidance for the financial solvency and market conduct regulation of insurers who offer CDAs. The guidance document is intended to serve as a reference for states interested in modifying their annuity laws to clarify their applicability to CDAs. It sets forth what consumer protection and financial solvency model laws and regulations should be applied to CDAs. The revised draft was updated on October 15 to incorporate comments received during the public comment period. The document was then re-exposed for a public comment period which ended on November 7.

In Washington, the working group noted that additional stylistic comments had been received from ACLI, AAA and the Insured Retirement Institute, which will be incorporated into the guidance document. The working group is waiting for other NAIC groups to develop a risk management checklist, reserve requirements, and capital requirements for CDAs. Once these have been completed, the guidance document will be updated and re-exposed for an additional public comment period.

In October, the working group also discussed comments received on previously exposed revisions to the *Annuity Disclosure Model Regulation*, the *Suitability in Annuity Transactions Model Regulation*, *Advertisements of Life Insurance and Annuities Model Regulation*, and the *Life Insurance and Annuities Replacement Model Regulation*. The most significant change was to remove the definition of CDAs in the proposed revisions to the model regulations and replace it with a definition of registered products which includes, but is not limited to, CDAs. The model regulations are not applicable to “registered products”; however, no definition existed previously. By adding this definition, the working group is clarifying that CDAs are excluded from the model regulations, but avoiding a precedent that they would need to reopen the model regulation for any new registered annuity product. The working group adopted the revisions to the model regulations at the Fall National Meeting. These revisions were subsequently adopted by Life Insurance and Annuities Committee.

In response to concerns raised by the Center for Economic Justice at the Summer National Meeting, the working group continues to consider whether a nonforfeiture benefit should be applicable to CDAs. In Washington, the working group noted a clear consensus that it favors some form of nonforfeiture benefit, and requested that industry propose some

options. A representative of the IRI agreed to discuss this with the limited number of life insurers that currently offer CDAs, but noted possible antitrust concerns with the industry working together to develop a common nonforfeiture benefit, which the working group did not appear to agree is an issue.

Receivership and Insolvency Task Force – The task force has completed its review of the CDA definition and determined that no amendments to the *Life and Health Insurance Guaranty Association Model Act* are warranted. The task force concluded that, in most states, CDAs would fall within the scope of annuities which are covered by guaranty associations under the Model Act.

Financial Regulation Standards and Accreditation Committee

The committee met in Washington and took the following actions.

Definition of Multi-State Insurer

At the Spring National Meeting, the committee exposed proposed changes to Part A and Part B of the accreditation standards definition of “multi-state insurer” which has been a controversial issue. Under the proposed definition, a multi-state reinsurer is an insurer assuming business that is directly written in more than one state and/or in any state other than its state of domicile. Captive insurers owned by non-insurance entities for the management of their own risk would continue to be exempted. All other captive insurers, special purpose vehicles and other entities assuming business in states other than their state of domicile would be subject to the accreditation standards under this proposal.

In Washington, the chair informed the audience that thirty-four comment letters had been received opposing the proposal due to the overly broad nature of the proposed revisions and the potential unintended consequences. The chair noted he has been working with NAIC staff to scale back the application of the proposed changes as it is not intended to apply to pure captive transactions. The revised definition was an attempt to address the lack of consistency and transparency in captive transactions, excluding future transactions that meet the requirements of the XXX/AXXX Reinsurance Framework when adopted and implemented.

The revised approach is for NAIC staff to draft new versions of the Part A and Part B Preambles which would include in the scope of the Accreditation Program captive insurers and special purpose vehicles that assume business written in accordance with the *Valuation of Life Insurance Policies Model*

Regulation (commonly referred to as “Regulation XXX”); *Actuarial Guidelines XXXVIII—The Application of the Valuation of Life Insurance Policies Model Regulation* (AG 38) (commonly referred to as “Regulation AXXX”), variable annuities valued under *Actuarial Guidelines XLIII—CARVM for Variable Annuities* (AG 43); and long-term care insurance valued under the *Health Insurance Reserves Model Regulation*. The revisions would have a prospective effect and a future effective date is to be determined. It is further recommended that NAIC staff provide a draft of the proposed revisions to the chair for exposure prior to year-end 2014.

2010 Holding Company Model Revisions

The committee heard an update on the adoption of the 2010 revisions to the Insurance Holding Company System Model Act (#440) and Regulation (#450). Thirty eight jurisdictions have enacted the revisions to the model act in full or in part, and many of these states have also promulgated the revisions to the model regulation. The 2010 revisions are required for accreditation purposes as of January 1, 2016, so all accredited jurisdictions will need to adopt the revisions during 2015. It was noted that the Group Solvency Issues Working Group is drafting further revisions to the model act to incorporate the authority to act as the group-wide supervisor; however states were asked to still proceed with the adoption of the 2010 revisions because the revisions related to group-wide supervision will be required to go through the seasoning process.

Financial Analysis Handbook Changes

The committee discussed and exposed a referral from the Financial Analysis Handbook Working Group for a comment period ending December 5. The referral includes proposed revisions to the Review Team Guidelines that would require analysts to perform analysis procedures for domestic insurers that cede to captive insurers or special purposes vehicles business written in accordance with Regulations XXX and AXXX. (See additional discussion below in the Handbook Working Group summary.)

Accredited States

The chair announced that the committee held a regulator-only meeting in Washington and voted to award continued accreditation to the insurance departments of Maryland, New York, Oregon and Washington. Accredited departments undergo a comprehensive, independent review every five years to ensure they continue to meet baseline financial solvency oversight standards.

Financial Analysis Handbook Working Group

On November 5, the working group discussed proposed amendments to the Financial Analysis Handbook regarding guidelines for Regulation XXX/AXXX captive reinsurance transactions and the two comment letters received during the exposure period. One comment relates to subsection 16.f.ii, which states: “The extent of refinancing risk present within the transaction may involve financing of long duration reserve liabilities with short or medium duration assets.” It was noted that nearly all such financings mature before the liabilities run off. Thus, the working group agreed to add clarifying language following the subsection that if the financing transaction is scheduled to mature when the best estimate amount that would need to be refinanced is a substantial percentage of statutory reserves, consider whether a) the terms of the transaction provide the insurer with flexibility to either refinance (with the same finance provider or a replacement finance provider) or to recapture without incurring a material reduction to the insurer’s total adjusted capital, or b) the insurer otherwise has a contingency plan to manage its capital at transaction maturity. The working group also discussed rejected comments, including a recommendation to remove refinancing risk as one of the factors the analyst should consider in his/her review; the working group agreed that refinancing risk should not be eliminated.

The working group also agreed with a suggestion to add a new procedure to Form D - Captive Reinsurance Transactions Subsection 16.f to consider whether the captive will be retroceding the business to any other affiliates or non-affiliates. Following the discussion, the working group adopted the enhancements to the Financial Analysis Handbook with the agreed-upon edits.

Casualty Actuarial and Statistical Task Force

Price Optimization

The task force received an update from the NAIC’s Auto Insurance Study Group noting that the study group has been focused on price optimization since December 2013. There are many views on what price optimization means and simply stated, price optimization is a statistical technique used by insurance companies to augment their judgment and make better decisions in the rate-setting process. In assessing the issue, the study group reached out to vendors of price optimization and heard presentations on the topic. In August, the study

group determined that price optimization goes beyond auto insurance and requires actuarial experience; thus the study group reached out to the task force in November seeking additional research on the use of price optimization and a request for a report or whitepaper documenting the relevant issues.

In Washington, the task force heard comments from the Casualty Actuarial Society which believes that there is a misunderstanding about what price optimization is. Per the CAS, price optimization has been around for a long time but has evolved in sophistication. It continues to be one component of the ratemaking process in how the business manager goes from actuarial rates to final prices. CAS noted that actuaries are a key part of the ratemaking process, and over time and with the advent of more detailed data and the statistical sophistication to handle very large data sets, actuaries now have the ability to provide quantitative information into some of the previously judgmental aspects of the price-setting process in lieu of anecdotal evidence. The ability to collect detailed data on risk retention, defecting clients, quote data, and closure rates by numerous risk characteristics has enhanced predictive modeling and risk-based pricing.

The AAA pointed out that price optimization has raised potential public policy issues. Whether the resulting rates are not excessive and not unfairly discriminatory remains to be a key question to which the AAA noted there is no data to determine the answer. One regulatory concern is whether price optimization is designed to find inert people who will not shop for insurance; the AAA recommended that regulators should consider evaluating whether an actuary is signing off on the resulting rates at the end of the process and then determine whether there should be regulatory constraints with respect to the range around the point estimate of loss costs.

A consumer representative noted that price optimization is banned in Maryland and illegal in California. It was noted that while price-optimizing consultants have advised airlines, hotels and other industries as to how to maximize their profits based on consumer demand, the same cannot be done for insurance companies because 1) insurance is required to be bought by the states and lenders; and 2) insurance rates, by law, cannot be excessive or unfairly discriminatory.

During the December 16 conference call, the task force discussed recommendations from Connecticut, Indiana and North Carolina on how the task force should proceed on this matter. Both Connecticut and Indiana suggested development of a whitepaper which would define price optimization and study the

issues. Following the discussion, the task force agreed to create a whitepaper on price optimization and NAIC staff was asked to draft an outline. The task force expects to conduct regular conference calls to finalize the outline and then begin work on the whitepaper.

Actuarial Education Survey

The task force continued discussion of its charge to evaluate the Society of Actuaries' new general insurance educational track and whether actuaries meeting those requirements should be permitted to sign actuarial opinions for NAIC property/casualty annual statements. In Washington, the task force discussed an independent review of SOA's general insurance actuarial education, who would perform the study and which party should fund it. No decisions were made by the task force and further discussion on this topic is planned for future calls.

U.S. Qualification Standards Attestation Form

The task force heard an update from the Actuary Appointed Subgroup that met three times to draft a comment letter in response to the American Academy of Actuaries' draft U.S. Qualification Standards Attestation Form. The purpose of the form is to help actuaries understand the qualification standards required to issue Statements of Actuarial Opinion in the U.S. and to provide the actuaries a means by which to demonstrate how they meet the standards. The form was developed for all lines of business for regulatory use but it could be used more broadly, e.g. for reporting to the board of directors. The draft comment letter included several suggestions for improvement, including a recommendation to separate the attestation into two attestations: one for general actuarial opinions and another for appointed actuaries. Following the update, the task force adopted the comment letter for submission to the AAA.

Risk-Focused Surveillance Working Group

The working group met by conference call on September 17 and December 16 and discussed the following topics.

Insurer Profile Summary and Group Profile Summary Templates

The working group discussed comments received on the previously exposed Insurer Profile Summary and Group Profile Summary Templates. The IPS is intended to provide a high-level overview of the current and prospective solvency of an insurer as well as the on-going regulatory plan to ensure effective supervision. The proposed GPS is a similar tool, and like the IPS, is to be updated each year

through the annual statement analysis process. The templates incorporate the use of a common language for the communication of solvency risks across monitoring functions and state insurance departments. As both the IPS and GPS templates would be included in both the Financial Examiners Handbook and the Financial Analysis Handbook, the common language selected for use in the templates is the “branded risk classifications,” which are already included both handbooks. There are nine branded risk classifications which include credit, legal, liquidity, market, operational, pricing/underwriting, reputation, reserving, and strategic. The classifications are intended to provide broad risk categories that can be used to classify and assess an insurer’s exposure to significant solvency risks that are identified through the solvency-monitoring processes.

The working group heard concerns regarding the confidentiality protection provided to information included within the IPS, given its use in sharing information across the states. A question was raised as to whether the information included in the IPS could be shared with the insurers so that they can have an opportunity to respond and address concerns highlighted within the document. The co-chair noted that the IPS has been shared across the states for a number of years and its confidentiality is protected under existing statutes and regulations. The co-chair also stated that the IPS is intended for use as a regulatory document, noting that issues or concerns highlighted within the document should have already been discussed between the regulator and the insurer through the normal course of solvency-monitoring activities. Therefore, it is not envisioned that the IPS would be provided to insurers for the communication of issues.

The working group also heard recommendations from several parties that adequate training of the analysts to enhance their skillset to complete a meaningful assessment of the insurer’s prospective exposure to each of the nine branded risk classifications, and the impact to the risk-focused examination, are critical if the proposed templates are to be implemented. There is also a concern that a prescriptive template with a heat map and the branded risk assessments could become more of a mechanical process than a meaningful assessment as analysts may focus too much on identifying a risk to fit the various classifications than on the significant prospective risk exposures for the specific insurer or group. The co-chair responded that they are working with NAIC staff to develop a training course in this area.

Several parties raised comments concerning the GPS in particular the need to consider the development of

group-wide reporting discussed by the Group Solvency Issues Working Group and other groups. Following the discussion, the working group acknowledged that while the IPS template appears ready to be finalized, there is still some confusion over the relationship between the holding company analysis requirements and the information included in the GPS template. The working group requested that the NAIC staff work on aligning the holding company analysis checklist with the GPS template and voted to refer the updated IPS template to the Financial Analysis Handbook Working Group and the Financial Examiners Handbook Technical Group for their consideration.

Redundancy in the U.S. Solvency Monitoring System

The working group discussed its charge to review existing examination and analysis procedures to identify and eliminate redundant efforts in collecting and reviewing insurer information for solvency-monitoring purposes. The co-chair observed that the working group has been cognizant of redundancy concerns in developing new guidance for analysts and examiners, which is why the ORSA and IPS guidance for both functions have been developed in tandem. However, there may be existing processes or reporting requirements that currently result in some level of duplication. Following the discussion, the working group voted to request public comments on areas of redundancy within the U.S. solvency monitoring system through October 31.

On its December 16 conference call, the working group discussed comments received from Connecticut, Virginia, a trade organization and joint interested parties noting support on the initiative undertaken by the working group. Connecticut suggested a good starting point would be the “Interested Parties Duplication Report” that was previously submitted to the Corporate Governance Working Group and where action is already underway. While Virginia agrees that redundancies can be eliminated, it cautioned for the working group to be “extremely cautious” before eliminating any analysis or examination procedures simply based on the fact that the insurer has filed, reported, and/or provided such information to the insurance department. Both the trade organization and joint interested party letters include specific recommendations and examples of possible redundancies.

Following the discussion, the chair asked interested parties to work on a matrix that combines comments on specific recommendations/examples. Additionally, the chair asked NAIC staff to review comments received as it relates to the Financial

Condition Examiners Handbook and propose changes to remove redundant requests or incorporate references if the analysts have requested similar documents. The working group will continue its discussion on this topic in future calls.

Climate Change and Global Warming Working Group

The working group heard a presentation from Ceres, a non-profit organization and an advocate for sustainability leadership. Its focus on the insurance industry is based on the fact that insurers provide clear and direct incentives to policyholders to reduce risks and increase investments in resiliency. Thus, the industry provides initial indicators of actual costs of climate change as it is both highly exposed to climate risks and able to finance clean energy investments. The presentation covered findings and recommendations on the NAIC Climate Risk Disclosure Survey for reporting year 2012. The survey was administered by California, New York, Connecticut and Minnesota, and included insurers writing more than \$100 million in direct written premium in these states, representing 87% of the industry. In total, the analysis covered 193 P/C insurers, 92 life and annuity insurers, and 45 health insurers.

There are eight qualitative survey questions that assess an insurer's climate risk strategy and preparedness. Ceres' analysis groups the eight questions into six climate risk management themes including climate risk governance, enterprise-wide climate risk management, climate change modeling and analytics, stakeholder engagement, internal greenhouse gas management and quality of climate risk disclosure.

Ceres utilizes a rating hierarchy of leading practices, developing practices, beginning practices and minimal information. Ceres' analysis noted, overall, that the P/C sector outperformed the health and life sectors with large insurers outperforming smaller companies. Most insurers did not report having implemented a comprehensive response to climate change risks and opportunities. Of the 193 P/C insurers that responded, 13 have leading climate risk governance practices, 15 have leading enterprise-wide climate risk management practices; 50 have leading practices in climate change and modeling and analytics, 10 have leading stakeholder engagement practices, 10 have leading practices in internal greenhouse gas management, and 30 have leading climate risk disclosure practices.

Ceres' recommendations for insurers are to:

- develop accountable climate risk oversight at the board and executive levels
- draft a comprehensive, public corporate statement on climate risk management
- integrate climate risk into ERM frameworks
- deepen the understanding of future climate change scenarios and impacts
- consider climate risks and opportunities in investment portfolios
- engage with key stakeholders on climate risk, and
- participate in joint industry initiatives on climate risk.

Ceres' recommendations for regulators are to:

- require climate risk disclosure in all states
- release an improved Climate Risk Disclosure Survey
- advocate for quantitative evaluation of insurers' climate risk management, and
- provide insurers with comprehensive climate science resources.

Following the presentation, the working group heard comments from companies and trade organizations, including a discussion on efforts in four counties in Florida which account for the bulk of its catastrophic risk. An observation was made by a trade organization representative that insurers are retreating from areas where they have unfavorable competition from residual markets. When pricing is suppressed, it allows for risk concentrations to build. The chair commented that regulators need to become more aggressive to make sure that coastal communities price in accordance with risk, particularly in soft market conditions. Further, he noted that the Ceres presentation was helpful in that there is now more buy-in as to how the insurance industry should tackle climate change risks.

Mortgage Guaranty Insurance Working Group

The working group met in Washington and discussed the following topics.

Revised Mortgage Guaranty Insurance Model Act

The working group discussed the third draft of the proposed Model Act, dated September 2014, which reflects some of the revisions requested by industry this fall. Those discussions included the following.

- Geographic Concentration (Section 5) - The state concentration limit was increased from 10% to 15% of net risk in force in any one state. Once the net risk exceeds 15% in a state, the mortgage

guaranty insurer would be subject to additional state concentration capital requirements provided by the Tier 1 and Tier 2 capital standards (which are still being developed).

- Reinsurance (Section 10) - Several participants pointed out that the Section 10D(5) which requires the reinsurer to collateralize 100% of its liabilities would conflict with the revised Credit for Reinsurance models and the Certified Reinsurer concept. On a separate reinsurance issue, the working group member from California strongly objected to the guidance that would not require either the ceding company or the reinsurer to hold the contingency reserve. The current wording does not require a reinsurer which is not a mortgage guaranty insurer to establish a contingency reserve.
- Rescission Relief Provisions (Section 16) – Several participants asked that Section 16B be deleted or revised because as written it will conflict with other state requirements.

No timetable was given for exposing a revised draft of the Model Act.

The working group also noted that a public conference call will be held to hear an update on the progress of the Oliver Wyman Capital Modeling Project. No potential dates were discussed.

Mortgage Guaranty Insurance Standards Manual

The working group heard an update on the development of a standards manual, which is referenced in the current version of the revised Model Act, in the Underwriting Documentation and Approval Considerations section. The working group previously agreed with industry representatives to include the proposed detailed underwriting standards outside the Model Act. The draft manual is a 45-page document covering the following topics: the private and public mortgage guaranty insurance environment, description of operating characteristics unique for mortgage insurance, risk environment, the Mortgage Guaranty Insurance Working Group's role and history, capital requirements and underwriting and quality assurance standards.

An industry representative asked whether the standards manual could instead be issued as a white paper, with the underwriting and quality control guidance placed in the Financial Examiners Handbook. One of the working group members noted that white papers can get "lost" a few years after issuance, and the working group would also be able to update the manual more easily if the guidance is not in the Handbook. The working group agreed the manual is not yet ready for formal

exposure and plans to allow additional time for review by the regulators with an official exposure in January.

Terrorism Insurance Implementation Working Group

The working group, which met via conference call in October and at the Fall National Meeting, has been monitoring the status of federal efforts to extend the Terrorism Risk Insurance Act (TRIA) which is set to expire on December 31, 2014.

In Washington, D.C., the working group reported that the NAIC sent a letter to the U.S. House of Representatives on September 9 in support of a long-term TRIA reauthorization. Insurance regulators, NAIC Staff and interested parties expressed concerns that Congress might not take the necessary actions to renew TRIA before it expires.

On December 10, the House passed a TRIA reauthorization bill by a vote of 417-7. The bill would have extended TRIA to 2020, increase the threshold for government reimbursement to kick-in from \$100 million to \$200 million, and increase insurers' co-payments from 15% to 20%. Both the increase to the threshold and co-payment levels would be phased in over a 5-year period. The bill approved by the House also included an unrelated provision which would exempt certain nonfinancial companies from the derivative trading regulations of the Dodd Frank Act. As the House bill was substantially different from the bill passed by the Senate in July, the pressure shifted back to the Senate to vote on the House bill, which then required the Senate to vote before the end of the legislative session. Senate Democrats expressed concerns with the proposed changes to the Dodd Frank Act within the bill; however, a Senate vote did not occur as Senator Tom Coburn (R., Okla.) prevented the bill from getting to the Senate floor due to his concerns about an unrelated provision. As the Senate did not take action, the TRIA provisions will expire on December 31. Congress will be under considerable pressure to reinstate TRIA in January.

The working group will continue to monitor actions taken by Congress in the coming year and, to the extent relevant, will update the model bulletin on filing procedures as well as related forms and disclosures.

Title Insurance Task Force

Title Guaranty Fund Model Guideline

In June 2014, the Title Insurance Guaranty Fund Working Group voted to expose its draft “Title Insurance Guaranty Association—Title Insurance Consumer Protection Fund Guideline” for public comment; a revised draft was subsequently exposed through November 20. The working group met by conference call December 1 noting that no comments were received. On the conference call, the working group discussed and clarified that “the association shall be obligated to the extent of the amount of covered claims unresolved prior to the determination of insolvency.” Several working group members discussed their experiences relating to issues from past insolvencies noting that the determination of what is covered by the guaranty fund is oftentimes a challenging task. Thus, the working group agreed to include drafting notes to provide states guidance on factors to consider and possible implications with state statutes. Changes to the guideline will be circulated to working group members for an e-vote on December 15.

Risk Retention Group Task Force

In Washington, the task force adopted its draft response to assist with a request from the Financial Regulation Standards and Accreditation Committee assessing whether a captive manager is, or could be considered, to have control of a risk retention group under the *Insurance Holding Company System Regulatory Act* or the *Insurance Holding Company System Model Regulation*. The response indicates that while captive managers do not typically exercise control over RRGs, lack of control should not be presumed in all cases. A factual determination should be made by the domiciliary regulator based on a review of the captive manager contract and the board of directors’ minutes to ensure that the captive manager’s role does not indicate control. Further, states should adopt the corporate governance standards of the Model Risk Retention Act, which will eventually be required for accreditation; the standards require that service provider contracts undergo a contract renewal at least every five years. If it is determined that a captive manager does control an RRG, the domiciliary regulator should ensure compliance with the holding company models.

The next National Meeting of the NAIC will be held in Phoenix March 28-31. 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@us.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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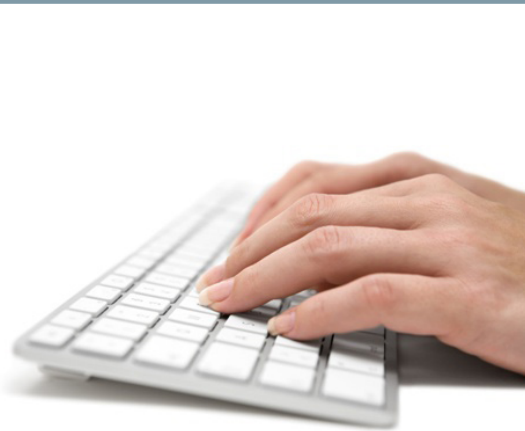
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AUTHORS WANTED

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, **Joseph Evans**, via sofe@sofe.org.

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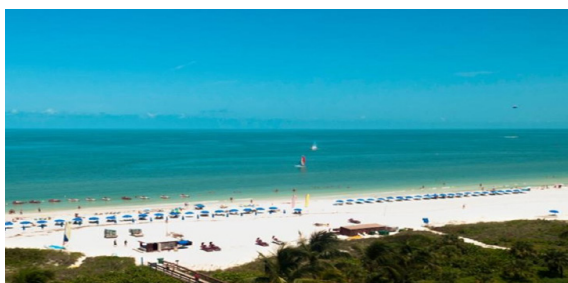
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