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IN THIS ISSUE

9 **SOX and Fraud Considerations During the Pandemic**
By Lewis Bivona, Jr., CPA, AFE
Assurity Resources, Inc.

12 **Efficiency in Getting to Phase 2**
By Phil Talerico, CPA, CFE, MCM and
Rachel Schmoyer, CPA, CISA
Baker Tilly Virchow Krause, LLP

18 **Market Briefing: U.S. Insurance Industry Invested Assets Following the Market Turmoil of 2020**
By Edward Toy
Risk & Regulatory Consulting, LLC

33 **Reasons a Captive Insurance Company is Beneficial**
By Leane Rafalko, CFE, ACI and Debra Walker, CPA, FLMI
NC Department of Insurance

42 **PwC NAIC Spring 2021 Newsletter**

61 **Mark Your Calendars for Upcoming SOFE Career Development Seminars**

CRE READING PROGRAM INSTRUCTIONS

The Society of Financial Examiners has a Reading Program for Earning Continuing Regulatory Education Credit by Reading the Articles in The Examiner.

You can earn **2 CRE credits** for each of the 4 quarterly issues by taking a simple, online test after reading each issue. There will be a total of 15-30 questions depending on the number of articles in the issue. The passing grade is 70%. To take the test, read all of the articles in the issue. Go to the Members section of the SOFE website to locate the online test. This is a password-protected area of the website, and you will need your username and password to access it. If you experience any difficulty logging into the Members section, please contact **sofe@sofe.org**.

NOTE: Each new test will be available online as soon as possible within a week of the publication release. The Reading Program online tests are free. Scoring is immediate upon submission of the online test. Retain a copy of your online test score in the event you are audited or you need the documentation for any other organization's CE requirements. Each test will remain active for one year or until there is a fifth test ready to be made available. In other words, there will only be tests available for credit for four quarters at any given time.

Earn Continuing Regulatory Education Credits by Reading The Examiner!

The questions are on the following page. Good luck!

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

CRE Reading Program Questions

All quizzes MUST be taken online.

*Questions will be **available online July 12, 2021.***

SOX and Fraud Considerations During the Pandemic

True and False Questions — Submit Answers Online

1. The ability to bypass internal controls within an organization has not been impacted by the pandemic.
   a. True
   b. False

2. Given the effects of the pandemic, Examiners should review closely any organization generated forward-looking forecasts.
   a. True
   b. False

3. Organization generated risk assessments should reflect any realities that were brought on by the pandemic.
   a. True
   b. False

4. Any financial stresses created by the pandemic could possibly lead to organization initiated fraudulent actions and/or activities.
   a. True
   b. False

5. The pandemic has resulted in more potential opportunities to override an organization's internal controls.
   a. True
   b. False

Efficiency in Getting to Phase 2

Multiple Choice and True or False Questions — Submit Answers Online

6. Which of the following is not one of the four critical points of efficiency in Phases 1 and 2 of a risk-focused examination?
   a. Keeping the Objective in Mind
   b. Order of Operational Risks
   c. Utilize the Tools We Have in Front of Us
   d. Leverage, Leverage, & Leverage

7. According to the Handbook, the primary purpose of a risk-focused examination is to review and evaluate an insurer's business processes and controls to assist in assessing and monitoring its current financial condition and historical solvency.
   a. True
   b. False

8. Which Handbook Exhibit is best described as the 'Examination Planning Questionnaire'?
   a. Exhibit A
   b. Exhibit B
   c. Exhibit C
   d. Exhibit D

9. Which of the following is not one of the leverage opportunities mentioned in the article?
   a. Audit Function
   b. Insurers
   c. Borrowed Capital
   d. Financial Analysts

10. An efficient risk-focused surveillance process should replace an insurer's risk-management activities.
    a. True
    b. False

Market Briefing: U.S. Insurance Industry Invested Assets Following the Market Turmoil of 2020

Multiple Choice and True or False Questions — Submit Answers Online

11. Downgrades by rating agencies and defaults for bonds increased in 2020 in comparison with prior years, but not to the degree that some analysts feared.
    a. True
    b. False

12. Notwithstanding the economic and market dislocations of 2020, it largely remained true that the insurance industry asset mix:
    a. Grew significantly
    b. Declined significantly
    c. Did not change much
    d. None of the above

13. The asset mix varies depending on the insurer type. Differences are significant between:
    a. Health insurers and P&C
    b. Life and Property & Casualty (P&C) insurers
    c. None of them
    d. All of them

14. Alternative investments may include:
    a. Bonds
    b. Real estate related assets
    c. Equities
    d. both b & c

15. The economic and market disruptions in 2020 had:
    a. Significant impact on all insurance companies
    b. A negative impact on all investors, including insurance companies
    c. No negative impact on insurance companies
    d. None of above

Reasons a Captive Insurance Company is Beneficial

True or False Questions — Submit Answers Online

16. Captive insurers will insure unaffiliated risks.
    a. True
    b. False

17. Captive insurers cannot write personal insurance lines of business directly.
    a. True
    b. False

18. One reason a captive is formed is because of limited availability of coverage .
    a. True
    b. False

19. All judications (domicile) have the same capital requirements for the captive.
    a. True
    b. False

20. The key to any successful relationship with the regulators is communication.
    a. True
    b. False

PwC NAIC Spring 2021 Newsletter

Multiple Choice and True or False Questions — Submit Answers Online

21. The Innovation and Technology Task Force have formed a working group to examine differences in digital business practices in order to create a white paper of best practices and potential recommended guidance to promote consistency and unified policies across the states.
    a. True
    b. False

22. Which of the following items were not adopted by the Blanks Working Group for 2021 annual statements and instructions:
    a. New Schedule Y Part 3
    b. New Health Care Receivables Supplement to the Life annual statement
    c. New Schedule Z added
    d. Modified the annual statement lines descriptions used in the Underwriting and Investments Exhibits in the P&C blank

23. The Statutory Accounting Principles Working Group has proposed for comment having cryptocurrencies be non-admitted assets
    a. True
    b. False

24. The Statutory Accounting Principles Working Group adopted proposed amendments to SSAP 25 to expand the definition of a related party to be consistent with US GAAP and SEC definition. Which of the following additional entities are related parties now?
    a. Any direct or indirect ownership greater than 10% of reporting entity, regardless of any disclaimer of control or disclaimer of affiliation
    b. Companies and entities which share common control, such as principal owners, directors of officers
    c. Any immediate family member of a principal owner, director or executive officer of the reporting entity
    d. All of the above

25. The Group Capital Calculation Working Group is working to develop a group calculation template, which may become an accreditation standard.
    a. True
    b. False

SOX and Fraud Considerations During the Pandemic

By Lewis Bivona, Jr., CPA, AFE
Assurity Resources, Inc.

Everyone has been stressed from the effects of the pandemic. Work restrictions required by the federal and state governments resulted in many employees working remotely. Lack of planning for off-site working can, and probably has, created an environment that allows for opportunities to bypass normal internal controls! That said, what should examiners be considering when planning and executing examinations post 2020?

Documentation that is normally available pre-pandemic for examination procedures may be unavailable or available electronically but potentially could have been modified to fool or mislead examiners. Additional procedures or requesting corroborating evidence may be necessary to obtain confidence in the provided information. From a budgetary perspective, examiners should consider discussing estimated increased procedures with the Department.

Examiners should also consider the validity of forward-looking forecasts. Many insurers have seen lower costs during the pandemic, for example:

- Health insurers had lower admission rates during the pandemic but costs can rise thereafter. Increased costs could occur due to higher vaccination related side effects and return to demands dulled by pandemic admission restrictions. Also, note that MLR calculations could be critical since lower costs could result in return of premium to insureds!
- Workers Compensation and Umbrella Liability policies could spike as damage claims related to employers mandating employee vaccinations of non-approved vaccines.
- Property & Casualty insurers noted spikes in losses due to lack of law enforcement actions during civil unrest. The current anti-law enforcement climate should be considered in potential loss monitoring.

As a result of the above, examiners should review the auditor's scrutiny and testing of management's assumptions, and if rudimentary, ask for additional corroborating evidence and/ or discuss your concerns with management.

Risk assessments should be reviewed with pandemic reality! If a company's risk assessments have not been modified from pre-pandemic levels, lack of evidence of discussions between Internal Audit and the Audit Committee, or management added risks, then a red flag should go off in the examiners head. Business is not as usual for many insurers post pandemic and thoughtful discussion and consideration of potential emerging risks should be noted and monitored! For public companies, examiners should note modifications to prior years SEC disclosures that address post pandemic critical risks to the company; if not available, the company and/ or the company's auditors should be queried as to why no modifications or disclosures were necessary!

In companies where financial stress created by the pandemic are expected, examiners should be particularly aware that fraud related to assumptions and estimates in the financial statements could be a problem. Examiners should review auditor work papers for testing of key estimates and also discuss concerns during your auditor interview. Auditor discussions with key company financial personnel should also note discussions of fraud or pressures to modify operating results.

Internal control testing, due to remote working, could have been less stringent during the pandemic when it should have been more robust. Employee, provider, or vendor fraud would be less likely to be caught with less testing of internal controls. Remote workers have more time to override controls and are less likely to be caught since peer and management oversight are lessened or non-existent. In addition, many companies instituted remote work environments in haste which could have weakened or inadvertently decreased normal processes and controls. Providers and vendors may also take advantage of the pandemic's relaxation of normal company internal controls by double billing or billing for services not rendered.

Even the Justice Department is getting into the COVID-19 fraud prosecution (see https://www.justice.gov/opa/pr/justice-department-takes-action-against-covid-19-fraud). The article noted, that "due to the COVID-19 pandemic, more than $860 billion in federal funds were appropriated for UI benefits through September 2021. Early investigation and analysis indicated that international organized criminal groups have targeted these funds by using stolen identities to file for UI benefits. Domestic fraudsters, ranging from identity thieves to prison inmates, have also committed UI fraud. In response, the department established the National Unemployment Insurance Fraud Task Force, a prosecutor-led multi-agency task force with representatives from more than eight different federal law enforcement agencies. Additionally, the department is hiring Assistant U.S. Attorneys in multiple U.S. Attorney's Offices whose focus will be UI fraud prosecutions. Since the start of the pandemic, over 140 defendants have been charged and arrested for federal offenses related to UI fraud. In one case, U.S. v. Leelynn Danielle Chytka, in the Western District of Virginia, a defendant recently pleaded guilty for her role in a scheme that successfully stole more than $499,000 in UI benefits using the identities of individuals ineligible for UI, including a number of prisoners."

The pandemic will be challenging for examiners and insurers, hopefully a little advice and thinking like a financial virus will keep us all from making mistakes in our pursuit of a competent examination!

About the Author

Lewis Bivona, Jr., **CPA, AFE** currently functions as a Market Regulation Examiner and a Financial Condition Examiner for Assurity Resources where his primary responsibilities include conducting and reviewing the practices and financial solvency of health and property and casualty companies. Prior to joining Assurity, Lewis was an SME for another major examination outsourcing firm. Prior to that he was the insurance practice partner for a large east coast regional firm which performed certified audits, financial condition examinations for various state insurance departments and targeted/due diligence examinations. Mr. Bivona also served as a deputy rehabilitator and/or liquidator for several insurance companies. Early in his career Lewis also was a regulator for the HMO industry in New Jersey. Lewis has served on the NAIC/AICPA Insurance Liaison Committee, the SOFE Examiner Publication Committee and the NAIC Accreditation Committee. Mr. Bivona is often a published author on insurance topics in several insurance outlets including Best Magazine, Insurance and Business, Employer Benefits and the SOFE Examiner where he won the Editor's Choice Award in 2014.

Efficiency in Getting to Phase 2

By Phil Talerico, CPA, CFE, MCM and Rachel Schmoyer, CPA, CISA Baker Tilly Virchow Krause, LLP

Pre-Planning, Phase 1, and Phase 2 sometimes can make-up about 30-40% of the examination budget! The purpose of this article is to discuss how to kick off your examination effectively, and how to better identify risks in Phase 2.

Pre-Planning & Request Efficiency:

"Just request it. " Three words that can have a material effect on an examination. How often do we find ourselves kicking off the exam and drafting a request list without even thinking through what is included on the Examination Planning Questionnaire, referenced as "Exhibit B", or can be provided by the analysts? Too often. Having participated in the preparation of an Exhibit B as part of other services to the industry, the amount of time required, and detail included is longer than you might expect. So why don't most of us take the time to start the examination off strong and map the information received from Exhibit B to the corresponding procedures within Teammate before making a single request? The NAIC Financial Condition Examination Handbook ("Handbook") guidance does indicate that "This questionnaire [Exhibit B] should be customized to the insurer being examined to allow the examiner or company personnel completing the questionnaire to focus only on the applicable questions." It seems fundamental, when you think about it, but often we as examiners default to the "just send the templated version" and "just request it" mentality. Don't believe us? We completed an initial verbal survey across our clients, and various insurance companies, and more often than not, the Company felt that most of the initial requests made were duplicative of the information provided in the Exhibit B.

We are constantly asking our Insurance Companies to be better through exceptions, and recommendations, so considering the feedback, how do we as examiners become better? There are a few ways that have been identified to start of the exam quickly and more efficiently:

1. Utilize Exhibit B to its fullest potential!!

    a. As mentioned above, Exhibit B is required for completion at the beginning of each exam. Instead of just reading through it, we have started to map the Exhibit B information to the various Teammate procedures. By doing this, we can quickly identify what we can complete before even starting the examination and what additional requests we may need. One question you may be asking is: what if the Company didn't take the time to complete Exhibit B, and where we thought we would be able to map, we cannot? Great question, and something we have struggled with as well; unfortunately, not all companies take the time needed. In these instances, what we have done, and seen success with, is provide that feedback to the Company. For example, within the request list we will say something along the lines of, "although mentioned within Exhibit B, can you please clarify… or … can you please provide the supporting documentation." Then during our scheduled status calls, we will follow-up with the Company and let them know for next time that if they elaborated on Exhibit B we could have reduced these requests on the request list. By explaining to the Company, we provide context to the request, and also increase the success of the next examination. It is all about collaboration!

2. Utilize the Financial Analyst

    a. This will sound like a broken record, but we believe the financial analyst is crucial to starting the exam effectively and efficiently. Having experience with the Company that spans the entire 4-to-5-year examination gap, the financial analyst will know the Company better than we will at the start of it. Further, the financial analyst is also gathering information during those 4-to-5 years, which could reduce the number of requests that we need to send to the Company. Our current practice is to gain access to their files and records. We then review the files for anything we will need in Planning, Phase 1, or Phase 2, and map those documents to the appropriate procedures within Teammate; similar to what was done with the Exhibit B requests. Lastly, if we believe the files we received are incomplete or missing a document, we follow-up with the financial analyst. This will save the Company time and reduce the potential comment "didn't we already provided this to the analyst."

3. Utilize data analytics and subscription resources to improve the efficiency of review of information

    a. We are constantly ensuring we have access to tools and insights that can provide value and efficiency to the Examination process. One resource we utilize is S&P Global, a subscription service that provides analytical tools as well as access to the insurance company's quarterly and annual fillings. Through the use of this tool, we were able to cut down requests by reducing the need for the Company to provide the annual or quarterly financial statements, supporting MD&A, audited financials, reinsurance and investment schedules, competitor analysis, and underwriting, reinsurance, and reserving trend reports. We are also able to convert all statements into Microsoft Excel which allows for an efficient completion of the high-level analytical review and assessment and calculation of materiality.

To summarize, utilizing the tools around you, and getting rid of the "just request it" methodology, sets ourselves up for reduced work, a more efficient jump-start to the examination, and a more responsive examinee. Remember – providing requests is not often part of their day-to-day activities, and by reducing the amount of work on the Company, we may find that the requests we do need are provided completely, and timely. Further, by taking the extra time to map in the requests we can better leverage our younger examiners, who do not have as much experience, understand the documentation without having to look for it or just make another request to the Company.

Risk-Focused Examination Purpose & Increasing Efficiency in Phase 1 & 2

Now that we have an idea of what information we need to request to complete Phase 1 and 2 of a risk focused examination; we should think about how we can efficiently and effectively utilize this information to get to our examination inherent risks. Before we share some of our thoughts on how to be efficient; we want to spend a few minutes going over the intent of a risk focused examinations. Setting this expectation at the beginning of the examination establishes a mindset for the examination team as it is performing the review of the Phase 1 and 2 procedures and activities; asking and answering the question, "does this activity support my end examination objective?"

The Handbook includes the following as the Purpose of Risk-Focused Examinations:

> *"The intent of the risk-focused surveillance process in a risk-focused examination is to determine areas of higher risk to enable more efficient use of examiner resources. The primary purpose of a risk-focused examination is to review and evaluate an insurer's business processes and controls (including the quality and reliability of corporate governance) to assist in assessing and monitoring its current financial condition and prospective solvency. As part of this process, the examiner identifies and evaluates risks that could cause an insurer's surplus to be materially misstated, both currently and prospectively."*

While this is obviously an accurate description of the purpose of a risk-focused examination; I do like to re-frame this definition slightly as I kick off engagements. See below for this re-framed definition:

> *The intent of the risk-focused surveillance process in a risk-focused examination is to determine **the insurer ability to identify** areas of higher risk, **which will be the focus of our** examiner resources. The primary purpose of a risk-focused examination is to **confirm that the** insurer's business processes, and controls (including the quality and reliability of corporate governance) **are developed to address the high-risk areas and** assist in assessing and monitoring its current financial condition and prospective solvency. As part of this process, the examiner identifies and evaluates **the insurer's identified** risks: **and others if necessary**, that could cause an insurer's surplus to be materially misstated, both currently and prospectively.*

While not all that different from the definition within the Handbook, the re-framed purpose provided here attempts to define the objective of a risk-focused examination as a process that ensures an insurer has an appropriate risk management function that provides confidence that risks are identified as they become significant and are factored into business processing in an attempt to preserve solvency. In addition to reviewing and ensuring that the current top risks are addressed.

We know that an insurers top risks are not fixed. A number of changing factors over time and additional external conditions impact the most significant risks at a specific point in time. Understanding that risks are dynamic and change over time, coupled with a risk-focused examination occurring every five (5) years, are the reasons why ensuring that an insurer has an effective risk management function is just as important and impactful for policyholders as reviewing the top risks as of the exam date or fieldwork date.

The risk-focused surveillance process should supplement/check to an insurer's risk management activities and not a replace it.

An Emphasis on Efficiency

The objectives of Phase 1 and 2 of an examination in one sentence is: to understand the operations of the insurer(s) under examination in order to identify the significant inherent risks. We are not proposing that those change; though we are questioning whether examination activities as currently performed are efficiently meeting these objectives. The current Handbook guidance for Phase 1 activities supports both the need for an examination team to be efficient and the desire to understand, leverage, and rely on the insurer's activities to support the exam.

One example of the Handbook guiding with efficiency in mind is within the updated Own Risk Solvency Assessment ("ORSA") review guidance. The ORSA review guidance notes that an examination that assesses ORSA / ERM as mature may ultimately limit the risks identified for the exam as those identified by the insurers ERM process. Further, a more established Handbook efficiency initiative is an examination's ability to leverage the work performed by the Audit Function of an insurer to reduce less significant financial reporting risks.

Both of these guidance points offer an opportunity for an examination to be efficient, requiring the examination to understand, assess, and determine appropriate reliance on insurer risk management activities.

Overall, what we are proposing here in this article is a mindset change that focuses an examination's effort on areas that will provide value to the insurer under examination and it's policyholders. In our opinion, changing the focus to understanding, assessing, and ensuring the insurer is implementing an effective risk management process provides more value versus the examiners identifying and assessing the significant risks. With any habit / mind set change, an intentional effort is needed by those involved to make the change and have it stick.

Efficiency in Practice & Conclusion

In summary, we live by four (4) critical points when starting an examination and moving into Phase 2:

1. **Utilize the Tools we have in front of us** – Customizing Exhibit B, obtaining financial analyst gathered information, and taking advantage of data analytics subscription services if possible, should be incorporated into our early examination procedures, prior to sending a request to the Company. By doing so, we will cut down the number of requests and allow the Company to focus on the requests we need, rather than being frustrated with documentation they believe they have already provided.

2. **Leverage, Leverage, & Leverage** – Reliance on the work of others (insurers, financial analysts, CPAs, rating agencies, etc.) should be a staple of every examination. But more so than understanding that we want to rely on the work of CPAs and Company auditors, we should be identifying what information do I already have and how can we be more effective in completing this procedure. Too often, examinations fail to identify how work already performed addresses a specific procedure step and duplicates efforts. As an example, why is there so much additional planning review in Phase 1 Part 1 when the most recent Insurer Profile Summary should be the primary document to support what examiners need to know as it relates to Phase 1 – Part 1 – Understanding the Company?

3. **Order of Operations** – Before jumping into an examination and working down the list of Phase 1 procedures; starting with Phase 1 – Part 1 – Understanding the Company. Think about the areas of this Phase where the value is derived in relation to the examination purpose we set. If an examination team starts with a review of the insurer's ERM / ORSA and the Audit Function the amount of leverage that the examination team can expect will be known. Assuming these assessments result in the greatest amount of leverage, an examination team will complete the remaining procedures in Phase 1 with the idea that there are no additional significant risks unidentified. Conversely, if these assessments result in issues and / or improvement recommendations, the examination team can be on alert for unidentified risks while completing these additional procedures.

4. **Keep the Objective in Mind** – Maintain and continue developing an agile mindset during Phase 1 and 2 by considering the value provided by completing procedures in an efficient manner. If no (or limited) value is to be provided as part of the examination process and it is not a required procedure, consider whether that procedure needs to be performed at all. With any change of this nature, an intentional effort to stick with it requires a commitment from those participating.

Overall, our perspective doesn't change the substance or purpose of the examination, or the guidance in the Handbook, it enhances it and allows for enhanced collaboration and communication with the Company on areas that are critical, rather than just providing the financial statements. We always should remember, the Company is not our enemy, they are a partner in the process of the examination, and we all want the examination to go well and end with meeting the objectives of the NAIC Financial Condition Risk Focused examination process. By creating that environment of communication, reduced redundancy, and increased reliance, we are setting ourselves up for success.

If you are interested in these ideas, please join us during SOFE CDS for the following presentations:

1. Dive into increasing the efficiency of the examination at kick-off and where we can better leverage: "Cactus if you Can – Get off to a Fast Start on your Examination" scheduled for Thursday, July 22nd at 12:00 PM EST.
2. Dive into increasing our capacity to understand critical risks: "Wandering the Desert in Search of an Inherent Risk Oasis" scheduled for Wednesday, July 21st at 3:10 PM EST.

About the Authors

Phil Talerico, CPA, CFE, MCM, is a manager at Baker Tilly within the Financial Services - Risk and Internal Audit Consulting group with eight years of experience in insurance regulation. Phil has been with Baker Tilly since June 2014 and prior was an Examiner with the Maryland Insurance Administration. Over the course of his career, Phil has served as an Examiner, Examiner-in-Charge, and as an Analyst performing Risk Focused Financial Examinations and Analysis. These regulatory engagements have included of Life, Health, and Property & Casualty Insurers entities as well as examinations for various State Insurance Departments over Captive Insurers. Phil holds the designation Certified Public Accountant, Certified Financial Examiner, and Market Conduct Management. Phil is a member of the Society of Financial Examiners, Maryland Association of Certified Public Accountants, Insurance Regulatory Examiners Society, and Institute of Internal Auditors.

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Market Briefing: U.S. Insurance Industry Invested Assets Following the Market Turmoil of 2020

By Edward Toy
Risk & Regulatory Consulting, LLC

Introduction

With the COVID-19 Pandemic and the resulting economic turmoil, 2020 was a very challenging year for investors in general, and that included U.S. insurance companies. With financial statement data available for year-end 2020, this is a good time to consider how investments may have changed for the different insurer types and how the market volatility during the year may have impacted those investments. By the end of the year, broad market indices had all recovered from the very dramatic downturn in March and April. However, the recovery was not across the board. Certain sectors and industries continued to struggle. Additional questions were also raised about longer-term prospects for others. In general, downgrades by rating agencies and defaults for bonds increased in 2020 in comparison with prior years, but not to the degree that some analysts feared. The same was true on the commercial real estate side, which is relevant given how the exposure has grown in recent years through commercial mortgage loans and investment real estate, particularly among Life insurers.

US Insurer Invested Assets

	Total Insurance Industry		Life Insurers		Property & Casualty Insurers		Health Insurers	
($000)	2019	2020	2019	2020	2019	2020	2019	2020
SHORT TERM INVESTMENTS								
ST Investments & Cash Equivalents	234,207,029	289,268,405	103,995,773	123,859,685	100,653,706	122,282,055	29,557,551	43,126,665
LONG TERM INVESTMENTS								
Corporate Bonds	2,297,854,079	2,493,529,290	1,871,517,729	2,016,375,234	371,946,857	413,432,448	54,389,492	63,721,608
Bank Loans	57,790,884	68,292,988	43,244,285	52,690,648	12,956,342	13,622,590	1,590,257	1,979,750
Government Bonds (incl Municipals)	810,733,807	831,119,580	380,143,385	393,040,630	392,440,487	394,948,673	38,149,936	43,130,277
Agency CMBS	79,010,434	78,056,027	50,472,186	49,147,036	26,426,681	26,527,754	2,111,567	2,381,237
Agency RMBS	283,498,724	260,317,344	164,959,870	144,877,922	96,489,182	91,648,334	22,049,673	23,791,088
Agency ABS	25,257,746	23,356,209	16,167,012	14,586,210	8,666,815	8,146,514	423,919	623,485
Non-Agency CMBS	185,536,782	193,025,773	139,058,304	142,078,403	40,539,962	43,694,484	5,938,516	7,252,886
Non-Agency RMBS	93,143,812	92,683,168	73,601,106	74,264,551	17,979,902	16,407,854	1,562,805	2,010,763
Non-Agency ABS	376,857,450	415,817,602	294,479,949	329,640,977	71,056,076	73,088,615	11,321,425	13,088,011
Hybrids	16,323,260	18,766,949	12,928,922	14,560,416	3,050,912	3,684,600	343,426	521,932
SVO Funds	8,685,414	14,088,321	3,219,718	6,055,922	2,767,122	4,502,047	2,698,573	3,530,352
Subtotal Unaffiliated Bonds	**4,234,692,392**	**4,489,053,251**	**3,049,792,465**	**3,237,317,949**	**1,044,320,339**	**1,089,703,914**	**140,579,588**	**162,031,389**
Preferred Stock	26,587,306	26,962,506	11,859,933	13,084,961	14,137,896	13,209,908	589,476	667,637
Common Stock	403,061,388	430,464,596	30,169,467	32,195,719	363,931,378	387,968,145	8,960,542	10,300,732
Funds reported as Common Stock	45,023,504	51,875,963	6,938,395	6,759,520	24,251,810	29,041,425	13,833,299	16,075,018
Subtotal Unaffiliated Equity	**474,672,197**	**509,303,065**	**48,967,796**	**52,040,200**	**402,321,084**	**430,219,479**	**23,383,317**	**27,043,387**
Commercial Mortgage Loans	521,655,332	541,882,684	501,712,901	520,715,772	19,759,577	20,987,004	182,854	179,907
Mezzanine Loans	10,400,921	10,343,103	9,400,998	9,667,870	999,922	675,233	-	-
Residential Mortgage Loans and Other	54,350,864	56,286,201	53,099,121	54,656,843	1,251,743	1,629,358	-	-
Problem Mortgages	1,472,695	2,753,695	1,304,874	2,306,348	167,822	447,347	-	-
Non-Insurer Occupied Real Estate	21,753,215	21,293,940	17,111,396	16,566,122	4,474,833	4,575,341	166,986	152,476
Subtotal Real Estate Related	**609,633,026**	**632,559,622**	**582,629,289**	**603,912,956**	**26,653,897**	**28,314,283**	**349,840**	**332,384**
Non-Conforming LT Assets	170,692,837	191,830,981	110,653,400	128,088,271	53,349,302	56,071,316	6,690,135	7,671,394
Affiliated Investments (incl Occupied RE)	742,668,851	809,826,720	272,062,892	292,129,511	434,130,612	477,778,577	36,475,347	39,918,632
Grand Total - Long Term Investments	**6,232,359,304**	**6,632,573,640**	**4,064,105,843**	**4,313,488,886**	**1,960,775,234**	**2,082,087,568**	**207,478,227**	**236,997,186**

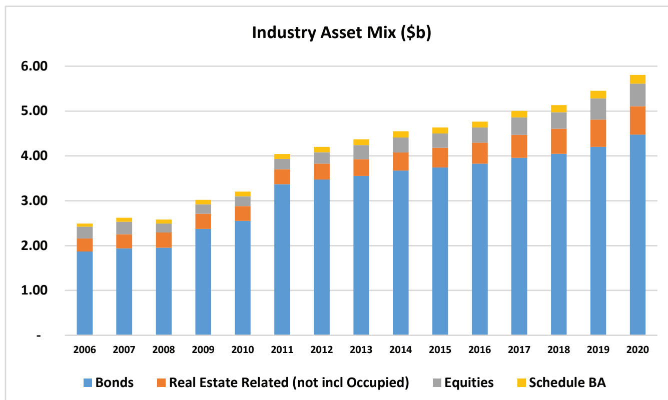
Notwithstanding the economic and market dislocations of 2020, it largely remained true that the insurance industry asset mix did not change much. Overall invested assets grew from $6.2 trillion to $6.6 trillion. Not counting affiliated investments, which as a general statement are not investments by insurers in market-based instruments, long term invested assets grew from $5.5 trillion to $5.8 trillion. Bonds continue to account for just slightly less than 75% of unaffiliated invested assets. Real estate related investments, primarily commercial mortgage loans held by Life insurers increased by approximately $23 billion, but as a percentage of assets actually declined slightly (from 10.65%

to 10.35%). Percentages increased for Cash and Short Term Investments, and increased slightly in the various equity lines and in Investments reported on Schedule BA, which are often also equity-related.

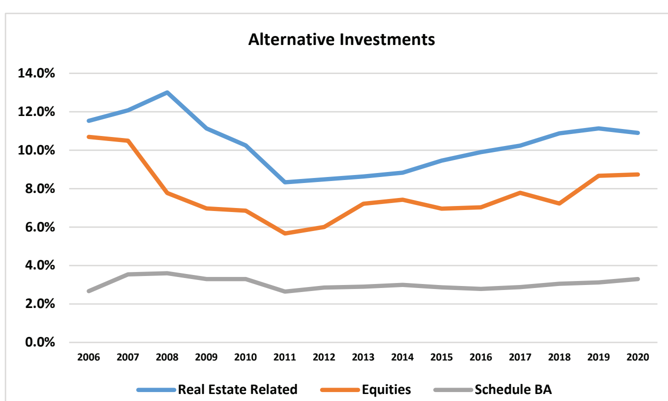
	Total Insurance Industry		Life Insurers		Property & Casualty Insurers		Health Insurers	
(as a pct of Unaffiliated Investments)	2019	2020	2019	2020	2019	2020	2019	2020
ST Investments & Cash Equivalents	4.09	4.73	2.67	2.99	6.19	7.08	14.74	17.95
Corporate Bonds	40.14	40.80	48.04	48.64	22.86	23.95	27.12	26.53
Bank Loans	1.01	1.12	1.11	1.27	0.80	0.79	0.79	0.82
Government Bonds (incl Municipals)	14.16	13.60	9.76	9.48	24.12	22.87	19.02	17.96
Agency CMBS	1.38	1.28	1.30	1.19	1.62	1.54	1.05	0.99
Agency RMBS	4.95	4.26	4.23	3.50	5.93	5.31	10.99	9.90
Agency ABS	0.44	0.38	0.41	0.35	0.53	0.47	0.21	0.26
Non-Agency CMBS	3.24	3.16	3.57	3.43	2.49	2.53	2.96	3.02
Non-Agency RMBS	1.63	1.52	1.89	1.79	1.10	0.95	0.78	0.84
Non-Agency ABS	6.58	6.80	7.56	7.95	4.37	4.23	5.64	5.45
Hybrids	0.29	0.31	0.33	0.35	0.19	0.21	0.17	0.22
SVO Funds	0.15	0.23	0.08	0.15	0.17	0.26	1.35	1.47
Subtotal Unaffiliated Bonds	**73.98**	**73.45**	**78.28**	**78.10**	**64.18**	**63.11**	**70.09**	**67.46**
Preferred Stock	0.46	0.44	0.30	0.32	0.87	0.77	0.29	0.28
Common Stock	7.04	7.04	0.77	0.78	22.36	22.47	4.47	4.29
Funds reported as Common Stock	0.79	0.85	0.18	0.16	1.49	1.68	6.90	6.69
Subtotal Unaffiliated Equity	**8.29**	**8.33**	**1.26**	**1.26**	**24.72**	**24.92**	**11.66**	**11.26**
Commercial Mortgage Loans	9.11	8.87	12.88	12.56	1.21	1.22	0.09	0.07
Mezzanine Loans	0.18	0.17	0.24	0.23	0.06	0.04	-	-
Residential Mortgage Loans and Other	0.95	0.92	1.36	1.32	0.08	0.09	-	-
Problem Mortgages	0.03	0.05	0.03	0.06	0.01	0.03	-	-
Non-Insurer Occupied Real Estate	0.38	0.35	0.44	0.40	0.27	0.26	0.08	0.06
Subtotal Real Estate Related	**10.65**	**10.35**	**14.95**	**14.57**	**1.64**	**1.64**	**0.17**	**0.14**
Non-Conforming LT Assets	2.98	3.14	2.84	3.09	3.28	3.25	3.34	3.19
Unaffiliated Invested Assets	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

As has always been important to remember, the asset mix varies depending on the insurer type. Differences are significant between Life and Property & Casualty (P&C) insurers, while Health insurers look relatively close to P&C. P&C insurers have much larger exposures to equities, though an important qualification to that statement is that some of that is driven by the equities exposure at a relatively small number of very large P&C insurers. Taking those larger entities out of the equation reduces the percentage of assets exposure to just a bit higher than 10%. That is still significantly higher than at Life insurers, but not the nearly 25% shown in the overall insurer type data. The overall equity exposure for P&C insurers has increased, from 21.7% of long term unaffiliated assets in 2006 to 26.8% in 2020, and as a percent of surplus from 29.9% in 2006 to 38.0% in 2020. Life insurers, on the other hand, have significant investments in real-estate related assets, mostly in commercial mortgage loans. As was the case with P&C insurers and equities, commercial mortgage loans are also particularly heavy at the larger Life companies. The larger Life insurers have been investors in commercial mortgage loans for decades and have been able to report solid performance. Even with the difficulties of 2020, reported problem loans were only 0.4% of the industry portfolio. Neither of the two tables above show differences in asset mix by size of insurer. As with equity exposure at P&C insurers, smaller insurers tend to be more conservative in their investments for all three of the basic risk parameters of credit, market and liquidity, than their larger counterparts.

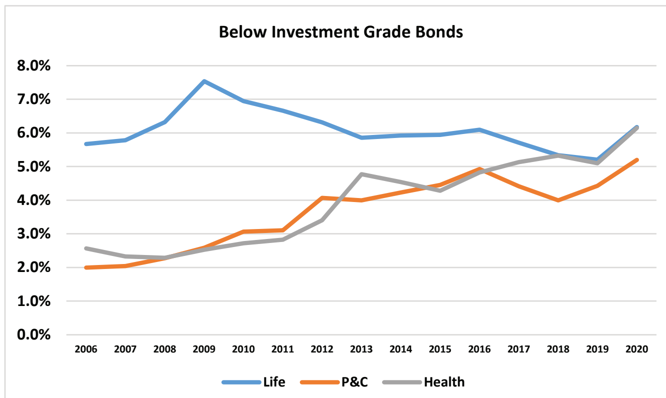
Taking the longer-term view, U.S. insurance industry assets have grown to the current level from roughly $2.5 trillion in 2006. That is an annualized growth rate of 6.2%. The major groupings have all grown at comparable rates: bonds at 6.4%, real estate related assets at 5.8% and equities at 4.7%. The fastest growing segment is also the smallest: Investments reported on Schedule BA, which has grown at 7.4%, but still only accounts for 3.14% of invested assets.



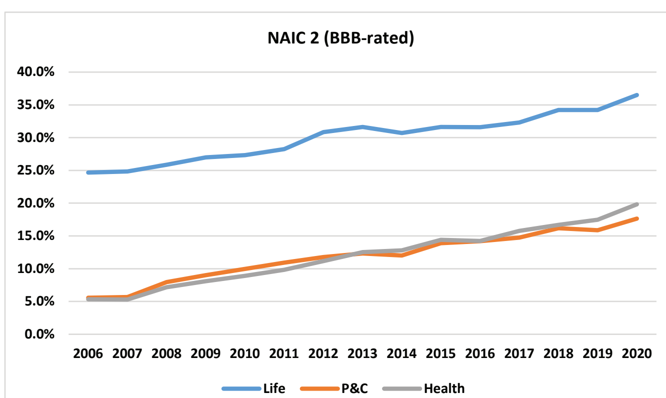
While bonds represent a dominant share of invested assets, analysts often focus on the increases in what could be termed "alternative investments" with the notion that these represent increases in different measures of investment risk that are in some sense not traditional. There are many different definitions of "alternative investments". Tracking the three groupings already mentioned, real estate related assets peaked in 2008 and has been increasing gradually since 2011. Equities followed a similar track. Investments reported on Schedule BA have been relatively static at about 3%.



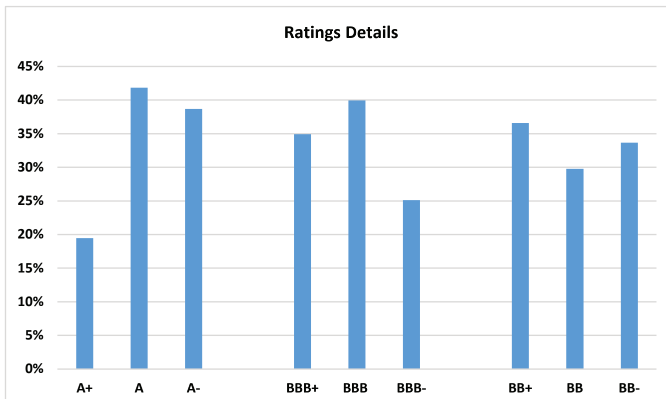
With interest rates and investment yields low, investors in general have had to look for ways to increase portfolio yields. Besides alternatives, one avenue frequently cited is increasing credit risk with below investment grade bonds. As a percent of total bonds, below investment grade exposure for Life insurers peaked in 2009 with the financial crisis and the resulting rating agency downgrades. There was a similar uptick in 2020, from 5.2% to 6.2%. P&C and Health insurers reported similar increases in 2020, but this was following gradually increasing numbers since 2006 when exposure with those insurer types were more generally in the 2.0% to 2.5% range.



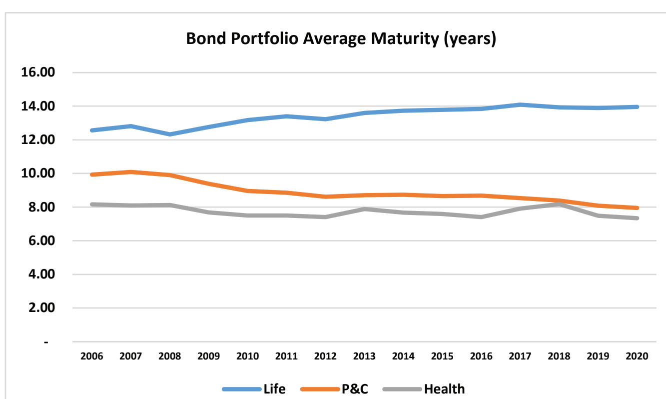
While still considered investment grade, bonds with a NAIC 2 Designation (BBB-rated) have also increased as a percentage of total bonds since 2006. Within investment grade bond holdings, these are most at risk of downgrade to below investment grade. This increase in exposure is also market driven as BBB-rated bonds have grown to represent 50% or more of the overall corporate bond investment grade market. For Life insurers, the exposure as a percent of total bonds has increased from 24.7% in 2006 to 36.5% in 2020. P&C and Health have seen incrementally larger increases, from 5.6% to 17.6% and from 5.4% to 19.8%, respectively.



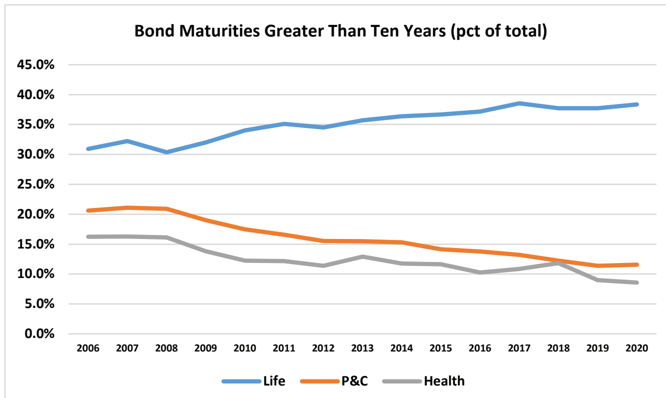
Beginning in 2020, the NAIC adopted new reporting guidance, adding granularity to the six NAIC Designations. This additional granularity is expected to be followed in 2021 with new, and more granular, Risk-Based Capital factors. As a first view of this new data, each of the groupings for A, BBB and BB were divided into the subcategories. Those in the lower end minus subcategory would be most at risk of downgrade to the next level. On an industry wide basis, there is no apparent weighting to A-minus or BBB-minus bonds. A downgrade to below investment grade would likely impact fair market values significantly.



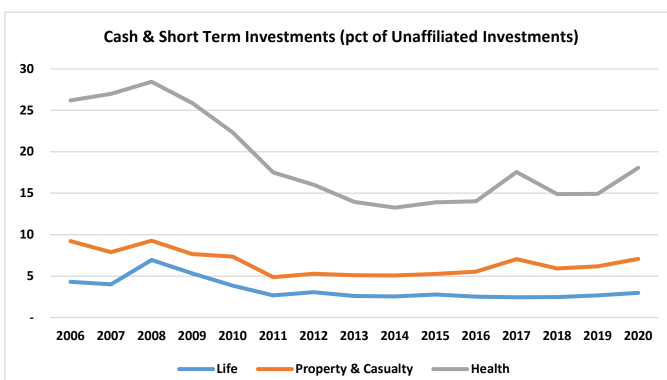
Using a simple measure weighting different bond maturities by carrying value of holdings, Life insurers have been gradually increasing the average maturity of the bond portfolios, to about 14 years, after a slight dip in 2008. P&C and Health insurers have overall seen gradual decline in the average maturity of their bond portfolios. While other factors impact the actual interest rate sensitivity of bonds, bond maturities are an indicator of overall direction of duration.



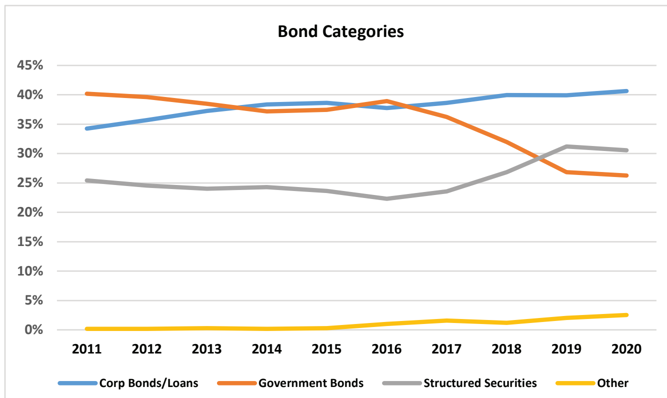
The most interest rate sensitive bonds will be those with the longest maturities, and likely the longest durations. Mirroring the data for average maturities is the percentage of bond portfolios with maturities greater than ten years. As interest rates have declined even further in 2020 with action taken by the Federal Reserve, bond coupons are lower which increases the interest rate sensitivity of bonds, all other factors being the same. At the longest end, an increase of 100 basis points in interest rates can negatively impact fair market values by 15 to 20 points.



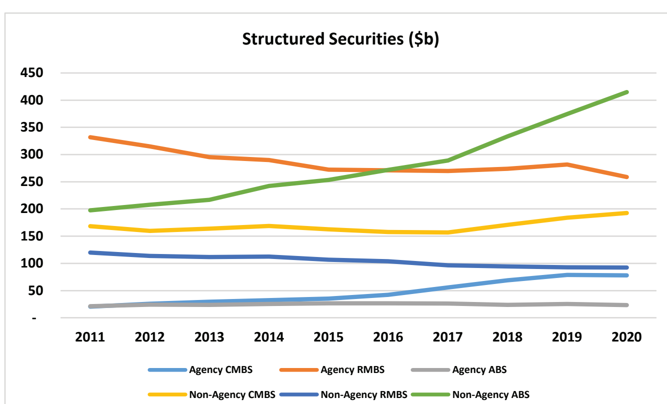
On the other end of the spectrum, with the market volatility of 2020, and some ongoing economic uncertainty, the three different insurer types modestly increased their holdings of cash and short term investments as a percent of total unaffiliated investments. This was after declines in all three of the percentages since 2008. Anecdotally, many insurers significantly increased their liquidity in the spring of 2020, with the height of uncertainty about the pandemic, through various means. As the uncertainty waned towards the end of the year, the incremental liquidity declined.



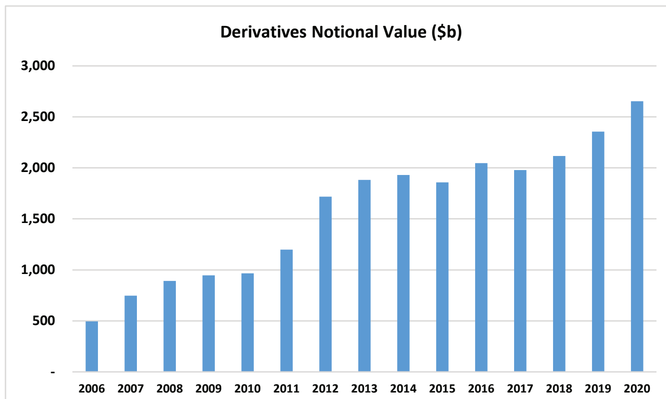
Within Bonds, the mix has fluctuated some between corporate issues (both bonds and loans), government bonds and structured securities. Most notable is a significant decline in government bond holdings as a percentage of the total from 2016 to 2019. With generally lower credit risk, government bonds tend to be considered a secondary source of liquidity. The decline in government bonds was mostly taken up by a net increase in different kinds of structured securities in the same period. While still not significant, there has been an increase in the other category which includes Bond Exchange Traded Funds (ETFs).



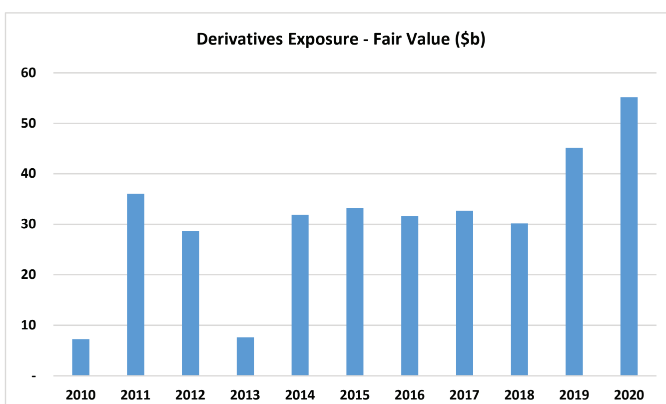
Over the last ten years, U.S. insurer investments in structured securities have increased from $859 billion in 2011 to $1.1 trillion in 2020, an overall increase of 23%. That growth has been entirely in non-agency asset-backed securities (ABS), as both agency and non-agency residential mortgaged-backed securities (RMBS) have declined. The $360 billion in RMBS still may present some concerns with prepayment variability. There has been some growth in commercial mortgage-backed securities, which is mostly non-agency. The growth in non-agency ABS has been a focus as it is driven by investments in collateralized loan obligations (CLOs).



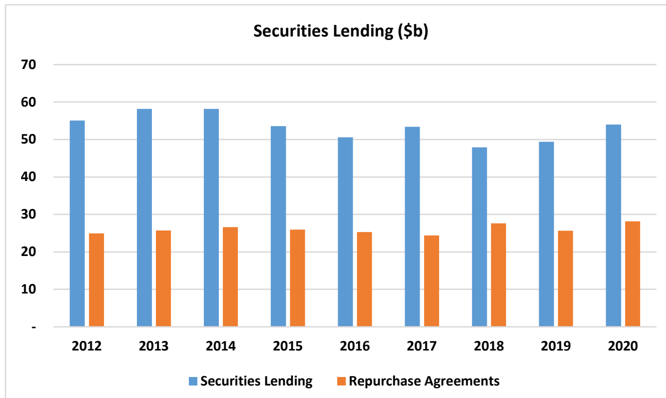
Derivatives notional value is not a good measure of actual risk, and the NAIC has made some changes over the years for what U.S. insurers should be reporting as notional value. Notwithstanding, as a general measure of the level of activity, insurers have continued to grow in their use of derivatives, in 2020 going over $2.65 trillion in notional value. Of that, $2.63 trillion is at Life insurers. U.S. insurers also continue to use derivatives almost entirely for hedging purposes, though a relatively small percentage is deemed to be Hedge-Effective for accounting purposes.



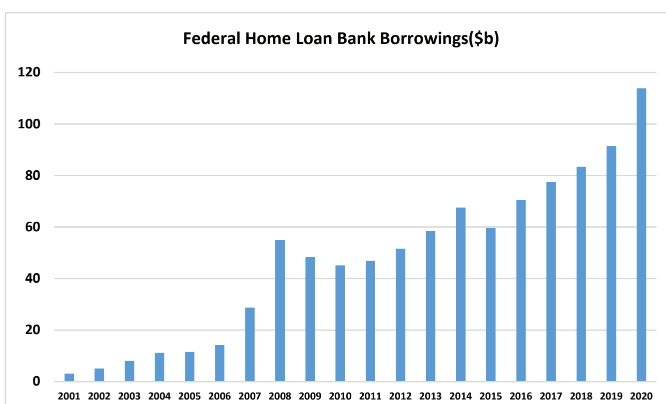
From the standpoint of risk assessment, still an imperfect measure, but something close to real exposure is the fair value of the U.S. insurance industry's derivatives positions which ended 2020 at $55.2 billion. There was also a net increase in this measure from 2018 to 2019, and again from 2019 to 2020. This is mostly, but not entirely, reflected in carrying value since any derivative not deemed to be Hedge-Effective for accounting purposes is carried at fair value. While the $55.2 billion also represents gross counter-party exposure, it is also collateralized by assets pledged to the insurer.



An issue that gained much notoriety with the 2008 financial crisis was the duration mismatch experienced by some insurers in securities lending activity, along with the economically similar repurchase agreements. With significantly enhanced disclosures, we can see that both securities lending and repurchase agreements activity have been relatively static in total since 2012.



Since the 2008 financial crisis, there has also been a dramatic growth in U.S. insurer membership with one of the Federal Home Loan Banks (FHLBs). In total, 57 insurer members grew to 528 members in 2020. Life insurers have tended to use the access to FHLB funding for spread investing, while P&C and Health have mostly joined to have access to FHLB for short term liquidity. This was after short term funding markets in many cases failed in 2008. Borrowing from FHLBs was one of the sources of additional liquidity previously mentioned in early 2020. Overall borrowings have increased from $3.1 billion in 2001 to $113.8 billion in 2020. Borrowings from FHLBs are required to be collateralized and the advance rate depends on the quality and liquidity of the collateral.



Markets

The focus of this Market Briefing has been on U.S. insurer asset mix, changes in 2020 from 2019 and a longer-term view over the last ten to fifteen years. Insurance company invested assets of course must be taken in the context of the overall market. A relatively low interest rate environment, coupled with a flat yield curve, was already a significant challenge to investors in general and insurers in particular. With the COVID-19 Pandemic, the Federal Reserve took extraordinary action to drive interest rates even lower. This included not just lowering short term interest targets, but also a $10 trillion buying program for longer dated bonds across many different asset classes.

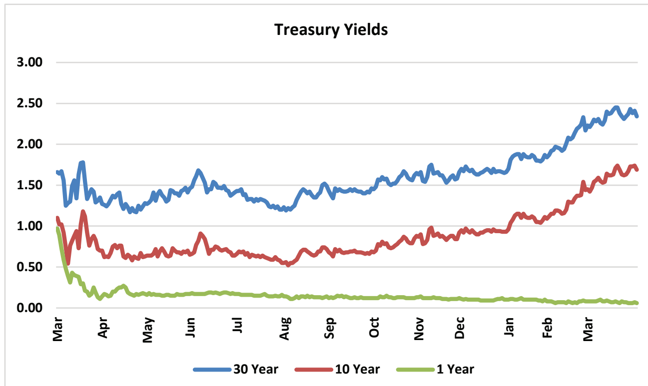
Default rates on all types of fixed income investments were expected to increase dramatically with the economic shutdown in 2020, which would also be reflected in the downgrade of bonds by rating agencies. All of that did come to pass, but not to the degree that some feared. Rating agencies expect defaults and downgrades to moderate but continue well into 2021 and perhaps into 2022.

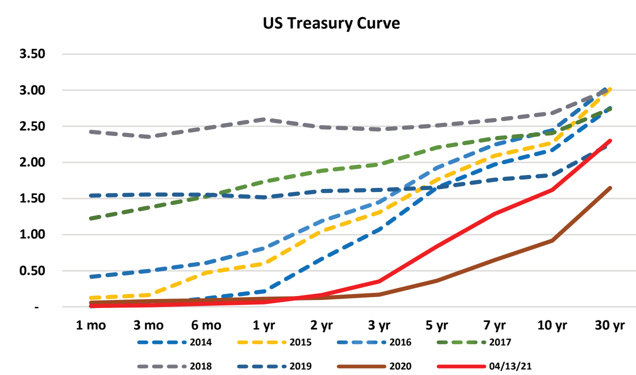
Equity markets in general dropped precipitously in the spring of 2020, by 30% in six weeks. This is compared with the 2008 financial crisis when equity markets declined a more significant 45%, but doing that over 18 months. Since the 2020 downturn, broad equity market indices recovered entirely by the end of the year, but the recovery was not across all industries and sectors. Those more affected by the economic shutdown, like travel and leisure, continued to struggle. Financial institutions, including insurance companies, also did not fully recover by year-end due to concerns about elevated defaults and lower portfolio yields with the lower interest rate environment. Thus far in the first quarter of 2021, the track of recovery in markets has continued and some of the previously lagging sectors have begun to catch up.

Following along with equity markets, credit spreads widened substantially in the second quarter of 2020. Also following equity markets, the broad bond market indices have also recovered. This has been more pronounced for now in the higher credit quality parts of the market. Lower credit quality bonds have also recovered substantially, but there remains a slightly wider differential between investment grade and below investment grade bonds. This is especially the case with structured securities as the credit support has diminished having a more significant impact on non-senior tranches.

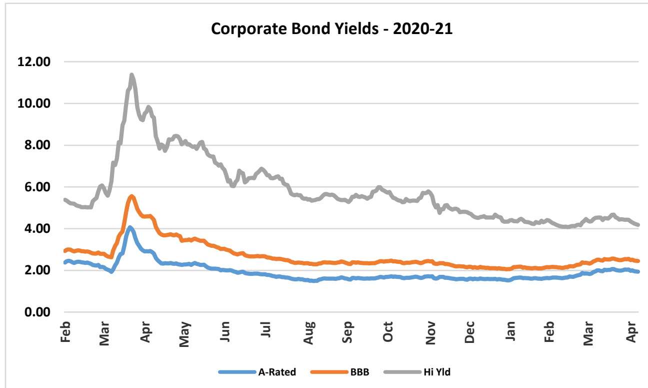
Also worth highlighting is the impact of the economic turmoil of 2020 on commercial real estate performance and values. The data available in 2020 to make a reasonable judgment on the impact was initially very sparse and not deemed entirely reliable. That has been improving significantly, though the overall assessments have not changed that much. Commercial real estate properties as an asset class remains rather idiosyncratic by nature, property by property, property-type by property-type and location by location. There does continue to be reasonable comfort with the apartment/multifamily sector. Retail, which was already struggling prior to 2020, took a substantial hit. Estimates for some parts of the retail sector were declines of as much as

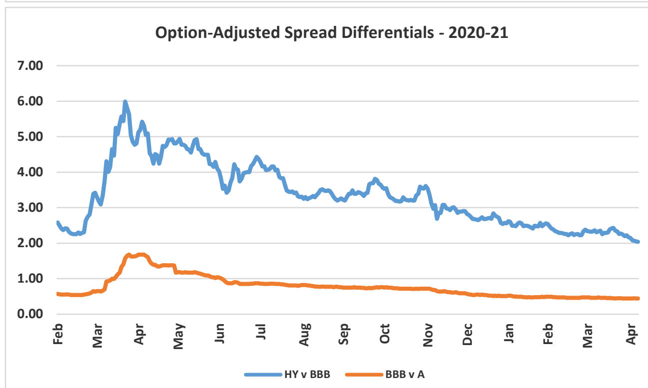
45% in value and generally a decline of 20 to 25%. Office property values have seen a modest decline so far, but there are concerns about the longer-term prospects as work-from-home programs may take a hold, especially in major metropolitan areas, which would reduce the need for office space in many cases.



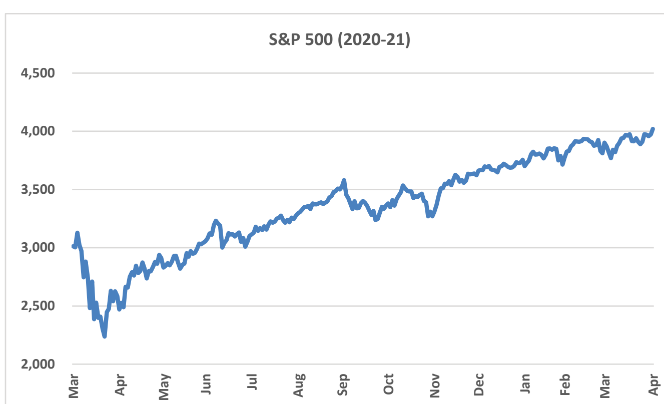


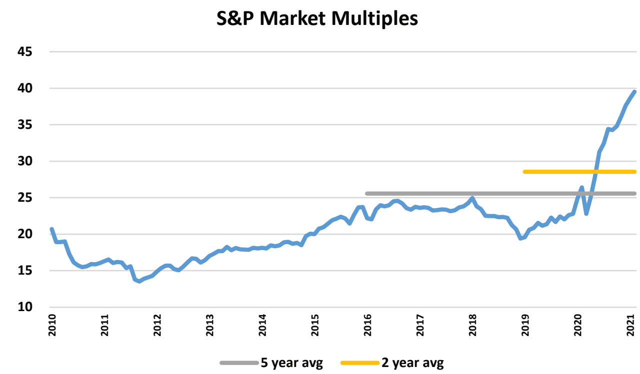
The Federal Reserve actions initially pushed interest rates down by 100 basis points or more across the entire yield curve. Since then, the 10-year and 30-year Treasury yields have been inching up. However, the current 1.6% yield on the 10-year Treasury is significantly lower than any recent year-end data point. At year-end 2013, the 10-year Treasury yield was 3.03%.



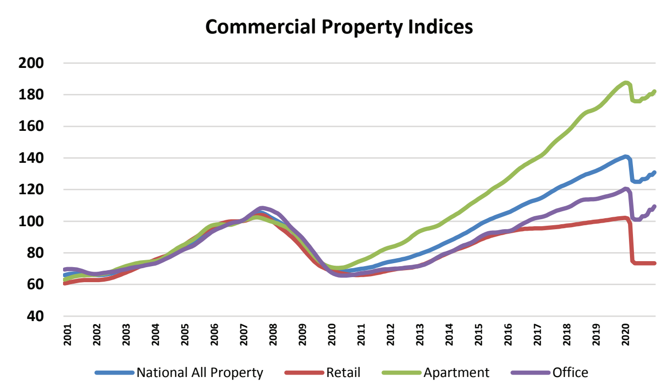


Corporate bond yields are a function of Treasury yields and option-adjusted spreads. With the spike in credit spreads in March 2020, yields climbed notwithstanding the drop in Treasury yields. Since then, credit spreads have moderated, and the still lower Treasury yields mean that corporate bond yields are currently lower than where they were at the beginning of 2020 before the pandemic. As interest rates begin to rise, corporate bond yields will also rise, which will negatively impact the fair market value of bond holdings. With a focus on the lower credit qualities and non-senior classes of bonds, there may also be some concern that those credit spreads may widen again if default rates do not continue to improve.





Overall, the S&P 500 index ended 2020 up 16.5% for the year, notwithstanding the tremendous drop in March 2020. An equity index of financial institutions was, however, down 4.2% for the year. From year-end 2020 so far this year, the S&P is up around 10% and financial institutions are doing somewhat better, up 18%, as default rates continue to moderate and longer-term interest rates have been improving. The dramatic recovery in broad equity market indices is outpacing recovery in earnings, which suffered dramatically with the economic shutdown and still higher unemployment rates. The estimated earnings multiple of nearly 40 times is far above any historic norm. While equity valuations should be more focused on forward looking earnings, the trend in the graph above that is based on current earnings is unmistakable and does point to some potential vulnerability in equity markets.



As noted already, data supporting commercial real estate indices has been improving, but continues to be somewhat less robust than before 2020. Various debt deferral and rent relief programs were instituted in 2020 and have been gradually winding down. Property sales on which appraisals rely for comparative analysis are fewer. Based on the available data, it does appear that values have largely recovered on the apartment-multifamily and office sectors. Retail continues to be down significantly, dragged down mainly by values for larger and older malls.

The (Totally Not) Final Word

The economic and market disruptions in 2020 had a negative impact on all investors, including insurance companies. On an industry-wide basis, and insurer-type by insurer-type, the impact does not appear to have been that significant. Taken in the context of the longer history, there was also nothing seen in the 2020 data that was substantially out of step. Many of the general trends prior to 2020 continued. Having said that, however, some individual companies are likely to have seen more of a negative impact. Those would be insurers that had more exposure to certain segments of the market. Examples of this would be: (a) larger below investment grade holdings that have gone or are at risk of going into default, (b) larger exposure to BBB-rated bonds, especially BBB-minus rated bonds, that got or are at risk of being downgraded to below investment grade, (c) larger equity exposures with sector concentrations that are still recovering, (d) higher risk investments in commercial real estate (those with lower debt service coverage ratios and higher loan-to-values before 2020), especially exposures to retail, (e) non-senior classes of structured securities that have seen their credit support permanently diminished or had payments blocked due to over-collateralization triggers, and (f) investments reported on Schedule BA, like private equity funds, that have experienced a disruption in sometimes complex investment strategies. Periods of economic and market disruption like that experienced in 2020 require a more granular analysis of the investment holdings of individual company portfolios.

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About the Author

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Reasons a Captive Insurance Company is Beneficial

By Leane Rafalko, CFE, ACI and Debra Walker, CPA, FLMI
NC Department of Insurance

Definition of Captive Insurance

What is captive insurance? In the simplest terms it is a formalized form of self-insurance where business owners capitalize and form their own insurance company to manage and finance their own business risks. While business owners are risking their financial resources in this endeavor, the rewards for doing so are numerous, including the potential profitability of their captive insurance companies instead of small or zero returns from premiums paid to commercial insurance companies, if loss experience is favorable.

Captive insurance companies operate like commercial insurance companies as they are legally formed, they receive an insurance license, they are regulated by insurance regulators, they underwrite insurance risks, issue insurance policies, collect insurance premiums, and adjudicate and pay claims. With the regulator's prior approval, captive insurance companies may also pay dividends or loan funds to their affiliates, like commercial insurance companies. In contrast, captive insurance companies are unlike commercial insurance companies as they do not market to the general public, they are regulated differently under separate laws, they may have smaller capital requirements, and they do not participate in state guaranty associations.

Types of Captive Insurance Companies

Once a business owner has made the decision to form a captive insurance company, the decision must be made about the type of captive insurance company that makes the most sense for meeting the business and insurance needs of that the owner's business. The most common captive insurance company type is the pure captive insurance company or single parent captive insurance company. A pure captive insurance company insures or reinsures risks of its parent, affiliated companies or controlled unaffiliated business. A business may demonstrate control over an unaffiliated business, which is a business that is not under common ownership of the captive insurance company and its affiliates, through a contractual relationship. A good example of a controlled unaffiliated business contractual relationship may be a relationship between a general contractor and its subcontractor, resulting in the general contractor's pure captive insurance company being able to insure the risks of its subcontractor. Since a pure captive insurance company is a legal entity, it must have officers and a governing body such as a board of directors, if it is a corporation, or managers, if it is formed as a limited liability company. As with commercial insurance companies, persons making up the governing body of a captive insurance company must submit a biographical affidavit to the regulator for vetting and approval for those persons to be a part of the governing body. The regulator will evaluate that information as part of the assessment of the experience, knowledge, and competence of the proposed governing board.

Another commonly used captive insurance structure is the protected cell captive insurance company. Protected cell captive insurance companies are also known as sponsored captive insurance companies. A sponsor of the protected cell captive insurance company provides the capital to organize and operate a protected cell captive insurance company. In some cases, a sponsor of a protected cell captive insurance company is a captive management firm, which forms the captive insurer for participation by its clients, and in this case, the insureds are usually unrelated to the sponsor. However, protected cell captive insurers may also be formed by a sponsor that has a relationship to the risks insured by the insurer. A captive manager, who is typically the first point of contact with the regulator, is responsible for the oversight of all the operations of a captive insurance company, including the accounting and financial statement preparation, regulatory filings with the regulator and coordination with other service providers such as auditors, actuaries, investment advisers, and attorneys. The participant of a protected cell captive insurance company is any person that is insured by the captive insurance company and any affiliate of that person. Individual participants or a group of participants may be insured through a protected cell, which may be incorporated or unincorporated.

Frequently, business owners that choose to participate through a protected cell structure are unrelated to the sponsor of the protected cell captive insurance company due to that structure's benefits such as cost efficiencies and lower capital requirements. These unrelated insureds of the protected captive insurance company pay a facility fee to the sponsor to access the captive insurance company. In some cases, participants may not be required to have their own capital at risk, own any of the captive insurer, or partake in the corporate governance yet they reap the benefits of a captive insurance company by insuring their own risks. The assets and liabilities of one protected cell are not permitted to be co-mingled with another protected cell by insurance statute. Each participant enters into a participation agreement with the protected cell captive insurance company through which the captive insurer provides insurance to the participant and limits losses of the captive to the assets of the protected cell.

Association, group, and industrial captive insurance companies have similar formation purposes. An association captive insurance company insures the risk of the members of an association or the risks of affiliated companies of the members of the association. A group captive insurance company insures the risks of either a heterogeneous or homogeneous group of unrelated insureds. Commercial business owners in the same industry may group together and form an industrial insured captive insurance company. Whether the captive insurance company is an association, group, or industrial, the insureds can spread risks and the cost of those risks among one another, lessening the brunt of a poor underwriting year for the participating insureds.

Lastly, insurance producers may form reinsurance agency captive insurance companies to share in the risks of their clients where those risks are directly insured by commercial carriers and ceded to the agents' captive insurance companies. Differing from other types of captive insurance companies, the owners of agency captive insurance companies do not obtain insurance from the agency captive insurance companies.

Coverages that Captive Insurers can directly write or reinsure

Since captive insurance companies are predominantly formed to insure the risks of their owners' businesses or affiliated businesses, they do not directly insure the general public. Additionally, any personal insurance lines of business such as personal automobile or homeowners' coverages cannot be directly written by a captive insurance company. Business owners are unable to have their captive insurance company directly insure their employees' workers' compensation, employer's liability or accident and health insurance. Other insurance coverages that are generally not permitted to be directly written by a captive insurance company are life and annuity products. However, there is a silver lining. While captive insurance companies cannot directly write these types of coverages, there may be other ways in which they are able to insure these risks through a captive insurance company. For instance, they can issue a deductible reimbursement policy to their affiliates to indemnify the expense paid by their affiliates for the self-insured retention or deductible of their respective commercial insurance policies. Another option available to business owners is for their captive insurance company to assume the aforementioned insurance coverages from a commercial insurance carrier. There are not any restrictions to the lines of business a captive insurance company may reinsure.

Reasons to form a Captive Insurer

There are many reasons to form a captive insurance company. Often captive insurance companies are formed by business owners because the insurance coverages needed to mitigate their business risks are not available or there is limited insurance capacity in the commercial market space. It may also be that the cost for commercial insurance coverage is too expensive. Gaps or exclusions in traditional insurance policies can be insured or reinsured through a captive insurance company. By employing a captive insurance company, it provides a business owner more control and flexibility in tailoring insurance terms and coverages to fit their exact insurance needs. Forming a captive insurance company also allows business owners to have more control over the underwriting of their insurance coverages and incentivizes loss prevention programs leading to lower claims cost, resulting in the ability to price the premium for insurance coverages based on the unique experience of those business owners.

A captive insurance company provides business owners direct access to reinsurance markets that have fewer regulatory obstacles and may provide coverage at a lower cost. As a captive insurance company matures and hopefully accumulates earnings if loss experience is favorable, premium pricing becomes more stable enabling the captive insurer to absorb a poor underwriting year or retain more risk. Those that form captive insurance companies select the third-party service providers, who will manage the insurance program.

Captive insurance companies are attractive to business owners as they pay premium to their own insurance company instead of a commercial insurance company, enabling the investment of those premium dollars since claim payments are paid out over a period of time. If there is favorable underwriting, premium dollars will also be retained. The longer a captive insurance company is in existence and accumulates these investment and premium dollars, the more likely the captive owner(s) will have the flexibility to invest in other types of investments that may yield a higher investment return.

Business owners may also decide to form their captive insurance company as a reinsurance captive insurance company that reinsures the risks of one or more fronting insurance carriers or traditional insurance companies, which have authority in each jurisdiction that they conduct business. Therefore, more of the regulatory burden is on the fronting or direct writing insurance companies issuing the policies. By assuming from these insurance companies, captive reinsurance companies are appealing as they are not required to obtain an insurance license in each jurisdiction where the risk is underwritten. They are only required to obtain a license from their sole regulator.

As noted above, there are certain insurance coverages a captive insurance company is unable to directly write. By utilizing a fronting carrier, business owners may finance certain risks through their reinsurance captive by assuming all or a portion of risk from the fronting carrier. When using a fronting carrier, business owners may save costs of insuring larger insurance limits on their risks because they are able to take on some or all of the risk by assuming that risk through their captive reinsurer.

Captive reinsurers can retrocede to other reinsurers, again allowing business owners to reduce costs by having their reinsurance captive insurer responsible for the working layer where most claims occur and retroceding aggregate layers or excess layers to a traditional insurance company. When the expertise for underwriting, loss control, and claims adjudication is warranted, captive reinsurers can benefit from the knowledge and experience of a fronting carrier.

Benefits of having a Captive Insurer during the pandemic

This past year, dealing with the repercussions of the pandemic, including business closings to disruptions in supply chains, has been tumultuous. Exclusions, such as business interruption losses from communicable diseases, in traditional insurance policies do not permit insureds to be indemnified for the revenue lost due to the pandemic. Some insureds of captive insurance companies have benefited from having coverages such as business interruption, administrative or regulatory action, supply chain or loss of key supplier, and accounts receivable risk from which they were reimbursed for losses caused by the pandemic. Administrative or regulatory action coverage provides insurance for losses sustained from business interruptions caused by government mandates. Many businesses suffered revenue losses from supply chain interruptions or losses of key suppliers where they were unable to provide the goods they sell to their customers. In some cases, payments of amounts due to businesses from others were delayed or were noncollectable because those owing those funds were also dealing with the pandemic issues and unable to meet their obligations. A captive insurance company is a possible solution for these types of situations.

Captive insurers were also useful during the recent pandemic in those cases where business owners were able to obtain funds through distributions or loans from their captive insurers, which had excess funding available. Having the access to those funds served as a lifeline for many businesses and allowed them to weather the storm caused by the pandemic.

For those business owners that did not have captive insurers during the pandemic, many are now realizing the benefits of owning a captive insurance company that provides the ability to underwrite specific risks of the insureds that are excluded from traditional insurance policies or too expensive in the traditional marketplace. Many businesses are now seeing the cost of their director and officer's liability insurance and error and omissions insurance skyrocket due to liability lawsuits caused by the pandemic. For some businesses that did not previously insure these risks through their captive insurance companies, their owners are seeking advice now on how to form their own insurance company to determine if it is feasible for them to do so.

Choosing a Domicile

Once a business owner has decided that it is feasible to form a captive insurance company, they must choose a domicile where they will establish the captive insurer. Since there are approximately 78 domiciles worldwide and 39 that are in the United States according to Captive.com, choosing a domicile is a crucial decision for a business owner as not all domiciles are alike.

When selecting the domicile to form and operate a captive insurer, the following aspects should be contemplated: the captive insurance laws of the domicile, the regulatory approach and costs of the domicile, the accessibility of captive insurance company service providers, and the domicile's lasting commitment to the industry.

Captive insurance laws are vital in deciding the appropriate domicile as you need to determine if the desired type of captive insurer and structure is available. A business owner would also need to know if the lines of business and coverage types, they intend for their captive insurer to provide are permissible in that domicile. Another factor that differs from domicile to domicile is the capital requirements and if there is any flexibility in those amounts. Other items to consider are domiciles' investment and reinsurance statutes such as: How conservative or liberal are a domicile's investment statutes, are there prescribed limits to the category of investments, and what type of transactions require prior approval? Do a domicile's statutes allow a captive insurer to insure or reinsure third party risk and what lines of business can be reinsured? The captive insurance laws of each domicile are important to review prior to deciding on one as they dictate the taxes and fees to be paid to the domicile as well as type and time-frame of the regulatory filings that are required. One last detail to ponder is how often a domicile's insurance laws are amended or updated to stay relevant with the evolvement of the captive insurance environment.

Potential captive owners need to evaluate a domicile's regulatory approach and costs. Several questions to ask when choosing a domicile may be: What is the number of staff, experience, and knowledge of the regulatory team, and how timely is that team in the completion of its evaluation of license applications and business plan changes? What is the responsiveness and accessibility of the domicile's captive insurance analysts to the captive insurance company owner, captive insurance manger or other service providers? Are the actions and decisions of the regulatory team applied consistently? Is the domicile's regulatory approach fair and reasonable? And do the captive insurance analysts act professional and aptly address all concerns? Finally, is it evident that the domicile is in it for the long-term?

The types and amounts of each domicile's regulatory costs differ from domicile to domicile. These imposed costs can be comprised of fees paid to the domicile to process, evaluate and examine license and business plan applications, financial filings, business plan changes, and dividend and loan requests. Based on the amount of premium written or assumed, each domicile has its own method of calculating premium taxes due to the domicile. Not all insurance departments employ in-house insurance examiners and analysts as well as actuaries, resulting in the outsourcing of consultants to perform financial analyses and examinations and actuarial reviews. When this occurs, the cost of these consultants is passed onto the captive insurer for reimbursement to the domicile.

To form a captive insurer and manage the operations, business owners need to rely on independent service providers such as captive managers, accountants, auditors, actuaries, attorneys, investment managers, and other professionals. Due to the significant reliance on these outside professionals, a potential captive owner will need to evaluate a domicile's accessibility to these individuals and firms.

Compliance with Captive Insurance Laws

Once a business owner selects a domicile and the captive insurer is formed, it is important for the captive insurance company and its services providers to be mindful of communication with the insurance regulators and compliance with the captive insurance laws.

The key to any successful relationship is communication. It is essential for captive insurers and their service providers to be as transparent as possible with the insurance regulatory team. By receiving advance notice of business plan changes, distribution requests or any material changes to the operations of the captive insurer provides, the insurance regulators gain a level of comfort with the captive insurance company and its service providers. When a captive insurer fails to obtain the domicile's prior approval of a material change to its operations or submits required filings untimely, this raises red flags. Responsiveness to the insurance regulators' inquiries is also considered a vital part of communication, and the absence of timely responses also raises red flags and elevates the insurance regulators' concern about the captive insurer. Having frequent contact with the domiciliary regulator allows for the discussion of any upcoming business plan changes or other requests as well as the insurance regulators' expectations or concerns and affords the immediate resolution of those issues.

The captive insurer's compliance with the domicile's captive insurance laws is fundamental and is of the utmost importance. To obtain an insurance license captive insurance companies must meet the requirements of the domicile's captive insurance laws. As they conduct insurance operations, captive insurers must remain in compliance with those laws. Many times, insurance licenses are approved with stipulations, such as the requirement to provide executed agreements within a specified period of time or to operate within the captive insurer's approved business plan. Captive insurance companies are required to comply with those license stipulations to maintain their insurance license.

Captive insurance companies are required to submit annual financial filings for the insurance regulators to assess their financial condition and determine compliance with their approved business plan. Insurance regulators are responsible for reviewing and evaluating the financial filings and addressing any issues that are discovered. As previously noted, any material business plan changes, such as changes to reinsurance programs, or certain transactions such as the issuance of dividends or affiliated loans must be pre-approved by the insurance regulators.

All required financial filings must be filed with the insurance regulators by the statutory due date unless an extension to a later due date or exemption is obtained from the regulator. Late filings or the submission of no filings at all raise red flags to the domicile. In order to avoid emails, telephone calls, and meetings from or with the regulator and to keep the regulator from having to take regulation action, such as additional filing requirements, financial examinations, or more serious actions such as license restrictions, suspensions and revocations, captive insurance companies simply need to comply with all of the domicile's insurance laws.

For a captive insurance company to be successful, attain the desired operational results, provide necessary insurance to its insureds, and maintain compliance with the domicile's insurance laws, the relationship between the captive insurance company and its insurance regulator is not only vital, but essential.

With the captive insurer and regulator working together, it is more likely that the captive insurer will remain in compliance with the captive laws, achieve the operational results outlined in its business plan, and provide its insureds with insurance benefits when they are needed.

About the Authors

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Debbie possesses more than 25 years of insurance regulatory experience. Prior to her appointment as Senior Deputy Commissioner, she held other the positions at the NCDOI including Deputy Commissioner and Director of Captive Insurance, responsible for the establishment and management of the NCDOI's captive insurance company regulatory operations. Before the 2013 enactment of North Carolina's captive enabling law, Debbie held the position of Chief Financial Analyst at the NCDOI for over 7 years, responsible for the financial regulatory oversight of all licensed insurers and other insurance entities regulated by the NCDOI. In addition, Debbie possesses varied insurance industry experience through positions she has held within the insurance industry.

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PwC NAIC Newsletter

Spring 2021

The National Association of Insurance Commissioners met in March and April in virtual Spring National Meetings. This newsletter contains information on activities that occurred in meetings since January 2021, with a focus on the virtual National Meetings and subsequent conference calls through April 30. For questions or comments on this Newsletter, please feel free to contact us at the address given on the last page.

In this issue

- Special Committee on Race and Insurance 2
- Group capital calculation 2
- Innovation and technology initiatives 3
- SAP Working Group 3
- Risk-based capital 5
- Valuation of Securities TF 7
- Blanks Working Group 8
- Accreditation Committee 9
- Principles-based reserving 9
- Life Actuarial Task Force 10
- Long-term care issues 11
- Life Insurance Committee 11
- Annuity suitability 11
- International Insurance Relations Committee 11
- Climate Risk 12
- P/C rate reviews 12
- Mortgage guaranty insurance issues 13
- Appendix A – SAPWG proposals 14
- Appendix B – RBC proposals 18

Executive Summary

- The Special Committee on Race and Insurance continued its work to develop recommendations to increase diversity and inclusion in the insurance industry, including tools to assess unfair discrimination in insurance transactions.
- The Group Capital Calculation Working Group has begun work on a trial implementation of its GCC template and instructions using 2020 data; the trial is expected to include a stress scenario to calculate GCC ratios at varying levels of stress, e.g. a 10% reduction in available capital.
- The Statutory Accounting Principles Working Group adopted 1) new guidance on extending the effective date of two Interpretations that provide COVID-related accounting relief, and 2) an expanded definition of "related parties." The working group also exposed for comment guidance on the non-admitted status of cryptocurrencies. An industry and regulator subgroup formed to draft a "principles-based definition of a Schedule D-1 bond" made significant progress this spring, with an exposure draft expected to be released for comment on May 20.
- All three RBC Working Groups exposed for comment separate proposed bond factors for the 20 NAIC Designation categories with a goal to adopt for 2021 RBC filings. The Life RBC Working Group also exposed the ACLI's real estate proposal and a revised longevity risk proposal (which includes five options on covariance), with a goal of 2021 adoption. The P/C RBC Working began its project to consider whether a wildfire peril risk charge should be added to the Rcat formula.
- The VOS Task Force adopted revised guidance for financially modeled RMBS and CMBS which will convert each rating (for non-legacy securities) to a single NAIC designation category versus the current 20 price breakpoints. The task force also continued progress on guidance on private rating letter rationale reports and possible revisions to the 5% threshold for residual risk limit on conforming credit tenant loans.
- The Blanks Working Group adopted a new Part 3 to Schedule Y to require additional disclosure of related parties and three proposals to gather additional health care data from Life, P/C and Health entities.
- The Life Actuarial Task Force had substantive discussions on its economic scenario generator project and allowing application of a prudent assumption on future mortality improvements.
- The Climate Risk and Resilience Task Force concluded no changes to the NAIC's Climate Risk Disclosure Survey will be required for 2021 filings but changes for 2022 will be considered in light of recent climate events and probable federal action on enhanced climate disclosures.

Executive Committee and Plenary

In addition to Executive Committee and Plenary adoptions discussed in various topics below, the Commissioners approved the following at the Spring National Meeting:

- ❖ Amendments to the NAIC's model Unfair Trade Practices Act (#880) to address anti-rebating and the inconsistent application of various states' unfair trade practices laws
- ❖ Regulatory Review of Predictive Models White Paper
- ❖ Real Property Lender-Placed Insurance Model Act
- ❖ Amendments to the Antifraud Plan Guideline
- ❖ Guideline for Administration of Large Deductible Policies in Receivership

Special Committee on Race and Insurance

During the Spring National Meeting, the recently formed Special Committee on Race and Insurance, which has been organized into five workstreams, heard updates on the progress of each workstream and discussed comments on their proposed 2021 charges that were exposed until May 12.

Workstreams 1 and 2, diversity and inclusion initiatives within 1) the insurance industry and insurance products and 2) within the NAIC and state regulatory community, have held multiple sessions. Workstream 1 submitted its initial findings, which are that the industry should do more to improve the level of D&I at all levels of insurance organizations. Workstream 1 is working on developing specific recommendations by continuing to engage with stakeholders and reviewing industry diversity programs and data. Workstream 2 developed a data gathering tool to assess state best practices and sent questions to the NAIC about their efforts.

Workstream 3, diversity and inclusion related to P/C products, streamlined its recommendations into its proposed charges, which in addition to access and affordability issues (i.e. "mitigating the effect of residual markets, premium financing and nonstandard markets on disadvantaged groups") include developing analytical tools for state insurance regulators to use in assessing unfair discrimination related to the following:

- Use of socioeconomic variables
- Identifying proxy variables for race
- Disparate impact considerations
- Use of third-party data
- Appropriateness of use of some data such as criminal history

For Workstream 4, diversity and inclusion related to the life insurance industry, charges include continued analysis of access and affordability, focusing on marketing, distribution, and access to life insurance products and the role of financial literacy. Workstream 4 also plans an analysis of unfair discrimination including the impact of accelerated underwriting, specifically the impact of traditional life insurance underwriting on minority populations and consideration of the relationship between mortality risk and disparate impact.

Workstream 5, diversity and inclusion related to the health industry, includes continued analysis of measures to advance equity by lowering the cost of healthcare, promoting access to care through advocacy of telehealth insurance coverage (post-pandemic), network adequacy and provider diversity, and outreach and education to consumers. Charges for workstream 3, 4, and 5 also include considering enhanced data reporting to identify demographics across product lines and a data call on products sold in specific ZIP codes to identify barriers to access.

In other new developments this spring, the New York Department of Financial Services created a new Office of Financial Inclusion and Empowerment to further its priority of economic justice.

Group capital calculation

Having completed the final version of group capital calculation (GCC) template and instructions and proposed revisions to the Insurance Holding Company System Act (#440) and Regulation (#450) to implement the filing of the GCC with the lead state commissioner, the GCC Working Group began discussions of a "GCC trial implementation" in 2021 and adoption of an annual GCC filing as an accreditation standard.

GCC 2022 implementation – The working group began discussions of a trial implementation to identify any issues with the GCC template and instructions using 2020 data. The working group currently envisions lead states will drive the process with assistance from NAIC, using approximately 30 volunteer companies. The regulators hope to start collecting 2020 data by June with completion by October with discussion at 2021 Fall National Meeting and adjustments to the template for 2022 implementation. During its April 27 meeting, the working group discussed its proposal for a stress test to inform regulators and users how the limits on recognition of capital instruments as capital behave under stress. The proposal scenario is as follows: a GCC group designs a "specific generic loss event that results in a proportional reduction in available capital across the Group's entire operations"; a 20% reduction will be tested as well.

The GCC template will automatically calculate outputs and resulting GCC ratios at varying levels of stress (e.g., 10%, 20% etc.) including the effect on the allowance for qualifying debt. Although the impact on adjusted carrying value in the stress scenario is generic, assumptions are not prescribed by the test. As part of the trial implementation, each group submitting data is requested to provide a "high-level narrative describing the unique assumptions used in conjunction with the corresponding decrease in available capital and calculated capital." The revised template, instructions and stress test were exposed for a short comment period.

Accreditation status - As discussed in the Accreditation Task Force summary, that task force exposed for comment a proposal to require the filing of the GCC template by all states as an accreditation standard by January 1, 2026. See page 9 for additional discussion.

Innovation and technology initiatives

During the Spring National Meeting, the Innovation and Technology Task Force heard updates from its working groups on key topics, including:

Big Data and AI Working Group – In 2021 these separate working groups were combined into one group, with a primary focus on understanding how the insurance industry is applying big data, algorithms and artificial intelligence. The working group will also study "governance structures that could be considered as best practices and guidance to state insurance regulators seeking to understand how the industry should be managing risks associated with the use of big data and AI." A first step in these projects is to develop a survey to gather information on how industry uses big data and AI, with the "likely focus" being on private passenger automobile insurance to limit the initial scope. A small group of regulators will work with NAIC staff to draft an industry survey for further review by the working group.

Regulatory relief in a pandemic - The task force discussed comments to its 2020 request for information on COVID-19 related regulatory relief/accommodations granted by states, focusing on three main areas:

- The need for consistent e-commerce rules and regulations (including e-signature, e-notary, and other digital business tools) noting that certain state rules still prohibit digital business practices
- Claims facilitation including the proper protection of consumer data, and
- Surplus line issues, including home state taxation and insurer eligibility issues, were referred to the Surplus Lines Task Force for its review and oversight.

Based on feedback received, the task force agreed to form a working group to examine state differences in digital business practices, which will result in a white paper of best practices and potential recommended guidance to promote consistency and unified policies across the states; work will begin later this year.

Statutory Accounting Principles Working Group

Significant actions taken by the SAP Working Group in 2021 are summarized below. (Appendix A to this Newsletter summarizes all actions taken by the working group thus far in 2021 and the status of all open projects.) The next meeting of the working group is scheduled for May 20.

Newly adopted guidance

<u>INT 20-03 & INT 20-07 extensions</u> – In January 2021, the SAP Working Group adopted a proposal to extend the effective date of COVID-related TDR relief for mortgage loans (INT 20-03) and certain mortgage loan-backed securities (INT 20-07) from December 31, 2020 to the earlier of January 1, 2022 or 60 days after the COVID national emergency is terminated. The revised effective date corresponds with the current effective dates of the CARES Act.

SSAP 25 related party and disclaimers of affiliation (#2019-34) – The working group adopted proposed amendments to SSAP 25 to expand the definition of a related party to be consistent with the U.S. GAAP and SEC definition, effective beginning the first quarter of 2021. Under the revised definition the following additional entities are related parties:

- any immediate family member of a principal owner, director or executive officer of the reporting entity (with definitions of specific relationships meeting “immediate family member”)
- companies and entities which share common control, such as principal owners, directors, or officers, including situations where a principal owners, directors, or officers have a controlling stake in another reporting entity, and
- any direct or indirect ownership greater than 10% of the reporting entity, regardless of any disclaimer of control or disclaimer of affiliation.

SSAP 25R also now includes guidance on when the presumption of non-control may be in doubt: agreements where direct or indirect non-controlling ownership interest is less than 10% where the parties have structured the arrangement to avoid the 10% threshold and related party classification.

The Blanks Working Group adopted a related proposal to require a new Part 3 to Schedule Y. See page 8 for further discussion.

SSAP 26R – Perpetual Bonds (#2020-22) — The SAP Working Group adopted proposed revisions that perpetual bonds with call features should apply the yield-to-worst amortization concept and be reported at amortized cost. Perpetual bonds without call features are to be reported at fair value. The revised guidance is effective as of the first quarter of 2021. Adoption represents a compromise with industry representatives since the original exposure would have required all perpetual bonds to be reported at fair value.

SSAP 32R – Preferred stock warrants (#2020-33) The regulators adopted revisions to scope publicly traded preferred stock warrants into SSAP 32R (and not in SSAP 86, Derivatives) and require that such warrants be reported at fair value, effective for the first quarter of 2021.

Significant exposures/discussions

SSAP 43R revisions (#2019-21) – The SAP Working Group continued its progress on its project to revise SSAP 43R to address regulatory concerns, especially with securitizations done with equity-like investments that become "transformed" into debt securities. In March of 2020 the working group exposed for comment an issue paper on loan-backed and structured securities. The proposed guidance provided new definitions of asset-backed securities, which industry commented would “have the potential for wide-ranging consequences affecting fixed income securities more generally.” As a result of the extensive comments received, the working group decided to halt further work on the March 2020 exposure draft for the time being.

Since December, a small group of industry representatives, the Iowa Insurance Division and NAIC staff have been working to develop a “principles-based definition of a bond to be reported on Schedule D, Part 1.” It is anticipated that the exposure draft of a proposed definition will focus on investments that reflects issuer credit obligations (repayment of which is supported primarily by the general creditworthiness of an operating entity or entities), and asset backed securities. Once the concepts and scope for Schedule D bonds are finalized, the SAP Working Group will then consider revisions to both SSAP 26R and SSAP 43R.

For investments that would no longer qualify for Schedule D-1, NAIC staff believes that these assets will likely be captured on Schedule BA, which will require input from the Capital Adequacy Task Force “to ensure that these investments are assessed for appropriate accounting, reporting and RBC.” The SAP Working Group plans to expose the revised bond definition during its upcoming May 20 conference call.

SSAP 2R/INT 21-01, Statutory Accounting Treatment for Cryptocurrencies (#2021-05) – The working group exposed for comment a proposed Interpretation that cryptocurrencies do not meet the definition of cash and should be classified as nonadmitted assets. The regulators also asked industry to provide feedback as to the level of interest and ownership in cryptocurrencies by insurers.

SSAP 86/INT 2020-01, ASU 2021-01, Reference Rate Reform (#2021-01) – The working group is proposing adoption of ASU 2021-01, which includes derivative contracts that undergo a transition to a new reference rate, but do not specifically refer to a rate that is expected to be discontinued. Derivative instruments that are modified to change the reference rate used for margining, discounting, or contract price alignment that is a result of reference rate reform are eligible for the exception guidance, through December 31, 2022.

SSAP 107 and state ACA reinsurance programs (#2021-09) – Although the Federal ACA reinsurance program was in place only for years 2014-2016, several states received approval from HHS to administer similar state ACA reinsurance programs. The goal of these programs is to lower individual health insurance premiums in those states. As these programs seek to operate in a manner similar to the Federal transitional reinsurance program, the initial recommendation of the working group exposed for comment is that such state programs should follow SSAP 107, to the extent the state programs have similar terms.

Risk-based capital

The regulators made the following significant progress on RBC projects. (Appendix B summarizes other actions taken by the various RBC Working Groups since January 2021.)

Life RBC

At the direction of the Financial Condition Committee, the chair of the Life RBC Working Group reiterated during many conference calls this year that the intent of the NAIC is to adopt revised bond and real estate factors for the Life RBC formula for year-end 2021. Further discussion of those projects and other significant developments is below.

Bond factors - With input from the Life RBC Working Group, the ACLI engaged a consultant, Moody's Analytics, to review the AAA's bond factor model, which the ACLI and other interested parties believe produces RBC bond factors that are too conservative. Moody's report was discussed by the Life RBC Working Group during a February conference call. The review by Moody's Analytics included both the defined scope of the AAA project, and a "much broader view, recognizing that the markets, techniques and data have evolved with capital markets." Their key finding included "areas of concern with regard to best practices with data and modeling choices and modeling documentation." Moody's report recommends their findings be implemented in two phases, with revised factors proposed by April 30 and a longer-term phase two, which would address modeling and data updates outside the AAA's defined scope.

After extensive discussion this spring, the Life RBC Working Group exposed the ACLI/Moody's bond factors, 2021-11-L, and updated proposed bond factors from the AAA, 2021-10-L for comment until May 27. The Academy's factors are those proposed in 2017, updated for tax changes that occurred subsequently. The Moody's factors are lower than the Academy's for the nine highest NAIC Designation categories (1A-1G and 2A-2B) and lower for 11 of the 20 categories. For both proposals, an impact analysis estimating the effect on RBC based on life insurers' 2020 bond holdings was expected to be available by April 30, but has been delayed.

Both proposals also include a portfolio adjustment factor to assess portfolio diversification. There is also an additional exposure, LR030 factor changes, to include explicit tax factors that are a part of the development of both sets of proposed base bond factors. Regulators and industry are asked to comment on key assumptions used in the models.

Real estate factors - The working group continued its review of the ACLI's proposed real estate factors for the Life RBC formula. Based on recent feedback from the working group and to add a margin for conservatism, the ACLI proposed an increase from its original proposed factor of 10% to 11% for Schedule A real estate and from 10% to 13% for Schedule BA real estate; the current charges are 15% for Schedule A and 23% for Schedule BA indirect equity investments in real estate. The proposal, 2021-06-L, was exposed for comment until May 24.

The ACLI real estate proposal introduces a new component to the formula which would adjust the base factor for 50% of the difference between the fair value and the carrying value (generally depreciated cost) of real estate on a property by property basis. Several regulators expressed concerns about the use of fair value of real estate to adjust the base factors and have asked for input from the SAP Working Group on the reliability of estimates of fair value for real estate. The ACLI proposal also includes a change to how real estate encumbrances are treated in the formula.

The final real estate factor would subject to a minimum of the Baa bond factor (1.30%) applied to the book adjusted carrying value, and a maximum of 45% of the BACV. The Life RBC Working Group exposed the ACLI's proposal for comment until May 24.

At its April 29 meeting, the Capital Adequacy Task Force adopted the RBC formula structure for the Real Estate Worksheet, 2021-01-L, which notes that the factor and instructions are not yet final.

Longevity risk – For year-end 2020 RBC filings, insurers holding "life contingent annuity reserves" disclosed reserves held on a new RBC page LR-025A, which was assessed a zero charge for 2020 as the Life RBC Working Group considered what covariance factor, if any, to apply. In April the working group resumed discussion and exposed for comment a complex proposal to assist the regulators in determining the final proposal, which they hope to adopt for 2021 RBC. The exposure, 2021-13-L, includes the following proposed factors and alternative covariance scenarios. After the exposure the working group will narrow down the choices and have another short exposure.

- Academy-proposed factors of 1.35% for the first $250 million of reserves held, 0.85% for the next $250 million, 0.75% for the next $500 million and 0.7% for reserves over $1 billion.
- Covariance of -0.25 with a guardrail of 1
- Covariance of -0.30 with a guardrail of 1
- Covariance of +1.0 (making C-2 mortality and C-2 longevity purely additive) with a guardrail of 1; (the guardrail will not alter the result since the calculation is additive)
- Covariance of -0.25 with no guardrail, and
- Covariance of -0.30 with no guardrail.

Per the working group chair, the purpose of the guardrail is to "prevent companies with material longevity exposure from major decreases in required capital earned from the diversification discount. [However], it also causes companies with significant longevity exposure but material mortality exposure to have potentially detrimental increases in required capital upon implementation."

Reciprocal reinsurers and reinsurance – The Life RBC Working Group also exposed for comment proposal 2021-12-L to revise the description of line 15 on LR016, Reinsurance, to allow for inclusion of amounts held for reciprocal jurisdiction reinsurance as part of the reinsurance payable credit, i.e. "Funds Held in Authorized Reinsurers and Funds Held in Reciprocal Jurisdiction Reinsurers." The proposed effective date is 2021 RBC filings.

P/C RBC

Bond factors – After the chair observed that the P/C RBC Working Group has been discussing updating bond factors for "a very long time," proposal 2021-08-P was exposed for comment until May 26. The impact analysis done using 2020 RBC filings showed only one insurer triggered an action level using the proposed factors (moving from "no action" to the trend test level) and that insurer was already very close to the threshold. The proposed effective date is 2021 RBC filings.

Wildfire risk – After numerous discussions and presentations to the subgroup over several years, the Catastrophe Risk Subgroup approved a project to consider adding wildfire peril to the catastrophe risk (Rcat) charge. During its Spring National Meeting, the chair of the subgroup reported that the regulators have recently met three times in regulator-only sessions to discuss wildfire models; more meetings will be scheduled to continue with in-depth technical reviews of different model assumptions, limitations and impact studies.

The chair asked interested parties to provide comments on the following issues: 1) key items that should be considered during development of a charge for wildfire risk, 2) whether to use the worst year in 100 in the calculation, and 3) what year should be the goal to implement a wildfire risk charge. The chair plans to form a technical review ad hoc group to analyze various wildfire forecasting models and asked for industry volunteers to join the ad hoc group.

Health RBC

Investment income adjustment factor – The Health RBC Working Group continued its discussion of the proposal to include an investment income adjustment factor in the underwriting risk H2 factors for XR012. The working group asked the American Academy of Actuaries to model factors for the most significant lines of business: comprehensive medical, Medicare supplement, dental and vision, and stand-alone Medicare Part D coverage. During its April conference call, the working group adopted for consideration by the Capital Adequacy Task Force proposal 2021-04-CA, which recommends a .5% investment return adjustment. (Medicare Part D will not be revised, as a result of the Academy's conclusion that any adjustment would be negligible since such coverage effectively has no claims lag.)

Once adopted, the adjustment factors would also be implemented for health coverages in the Life and

P/C RBC formulas. The working group also plans to expand the adjustment factors into other health lines of business in 2022 or later.

Health RBC bond factor proposal– The Health RBC Working Group discussed the NAIC's impact analysis of the effect on ACL of use of the Academy's proposed factors under both a two year and five-year time horizon for bond investments by health entities. The analysis shows approximately a 5% increase is required capital under both time horizons. The working group exposed for comment proposal 2021-09-H, which incorporates the factors for the 20 NAIC Designation Categories using the five-year time horizon for pages XR006, XR007 and XR012, with a proposed effective date of 2021 RBC filings.

Health care receivable factors – The Health RBC Working Group has been studying the need to revise the RBC charges for all heath care receivables. The regulators have concluded that data quality needs to be improved before revised factors can be considered. In March the Blanks Working Group adopted three proposals (2020-32, 2020-32 and 2020-38BWG) effective year-end 2021 to make reporting of health care receivables and other health data more consistent across all entities, which will also allow more analysis at the nationwide level. (See page 8 for additional detail.) The information gathered 2020 through 2022 will be used to develop the health care receivable RBC factors.

Valuation of Securities Task Force

The task force had significant activity with the adoption and exposure of the following items.

P&P Manual amendment adoptions

Financially modeled RMBS/CMBS securities – The task force previously amended the P&P manual to add instructions to map the financially modeled RMBS and CMBS NAIC designations based on current price breakpoints to the 20 new NAIC designation categories. This resulted in unusual results during the year-end 2020 modeling related to zero loss securities due to more conservative economic scenarios that reflected the pandemic coupled with current interest rates that caused the securities to be carried at a premium; this resulted in lower NAIC ratings not related to underlying credit. These securities were previously mapped to category 1D regardless of the insurer's book adjusted carrying value as a temporary measure as the task force moved forward with a project for a longer-term solution.

During the Spring National Meeting, the task force adopted a long-term solution, where, instead of converting the intrinsic price into a series of book adjusted carrying value price breakpoints, the securities' ratings will be converted into a single designation category using the NAIC Designation Intrinsic Price Mapping, which applies to all non-legacy securities (financially modeled RMBS/CMBS securities that closed on or after January 1, 2013). Legacy securities (financially modeled RMBS/CMBS securities that closed before January 1, 2013) will continue to use the book adjusted carry value methodology. This solution was adopted with a year-end 2021 adoption date, but the task force acknowledged they may have to revisit later in the year if a 2022 implementation date is more appropriate given technology constraints.

Use and regulation of derivatives in ETFs - In response to an SVO report that discusses the use and regulation of derivatives in exchange traded funds and the SEC's adoption of Rule 18f-4 which includes a derivative risk management program requirement and a value-at-risk (VaR) based limit on leverage, the SVO adopted two new tests to assess whether a fund's use of derivatives is consistent with a fixed income-like security similar to the SEC "limited user of derivatives" exception.

The first test is for funds other than funds on the NAIC Fixed Income-Like SEC Registered Funds List, where the gross notional amount of derivatives cannot exceed 10% of net asset value of the fund with some exceptions. The second test is for funds on the NAIC Fixed Income-Like SEC Registered Funds List which may be permitted a larger derivative threshold of up to 20% of the net asset value of the fund.

P&P Manual amendment exposures

Private Rating Letter Rationale Reports - The task force adopted a new charge for 2021 to "implement policies to oversee the NAIC's staff administration of rating agency ratings used in NAIC processes, including, staff's discretion over the applicability of their use in its administration of Filing Exemption." As part of the research leading to the new charge, in 2020, the task force exposed an SVO issue paper on concerns about bespoke securities and reliance on CRP ratings. These bespoke securities are not broadly syndicated and are usually privately rated by only one credit rating provider. There were several recommendations in the issue paper including monitoring and evaluating rating agency activities, and one of the first steps the SVO is taking is increasing their scrutiny over private letter securities.

Last November, the task force proposed an amendment to the P&P manual, effective January 1, 2022, to require that "private letter rationale reports" be filed with the SVO, in addition to the private letter received either directly or through a CRP rating feed. The reports will be reviewed to determine if the security is eligible to receive an NAIC Designation with a NAIC CRP Credit Rating but "without the SVO's discretion over evaluating the appropriateness of the rating or methodology utilized, at least at this time."

This spring additional updates were made to the proposal to include transition language as follows:

- For "waived submission PLR (private letter rated) securities" issued from January 1, 2018 to December 31, 2021, for which the private rating rationale report cannot be provided due to confidentiality or contractual concerns, insurers should report the securities as PGLI, which requires a certification in the General Interrogatories (item 34).

- For "deferred submission PLR securities" issued after January 1, 2022, for which the private rating rationale report cannot be provided due to confidentiality or contractual concerns, insurers may report that security as PGLI until December 31, 2023, and then must report it as NAIC 5GI thereafter, if a report is still not provided.

On the content of the report, the SVO also clarified they expect the private rating rationale report to be comparable to public reports published for that same asset class. The proposed amendments were exposed for comment until May 12.

Nonconforming credit tenant loans – In January 2021, the SAP Working Group adopted INT 20-10, Reporting Nonconforming Credit Tenant Loans, that provides a limited-time exception to the instructions in the SVO P&P Manual for nonconforming CTL transactions (leased-backed securities that do not meet the definition of a CTL or ground finance lease, and although rated, are not to be eligible for filing exempt).

As part of its project for a long-term solution, the task force received a referral from SAPWG on whether it is appropriate to increase the 5% residual threshold when determining whether a CTL is conforming. The SVO has not yet formalized its recommendation, but at the Spring National Meeting, SVO representatives reported that in the interim they feel they can safely go to a 50% residual threshold, with analysis of CTLs that exceed 50% on a case by case basis to see if there are other mitigating factors. The 50% residual threshold was noted as being consistent with the code of federal regulations for asset-backed and lease-backed securities, which is also accepted by the SEC.

Blanks Working Group

The working group adopted in March the following significant changes to the 2021 annual statements and instructions. All adopted changes are summarized by the Blanks Working Group on their webpage.

- Add a new Schedule Y, Part 3 to include all entities with ownership greater than 10% of an insurance entity, the ultimate controlling parties of those owners and other entities that the ultimate controlling party controls (2020-37BWG). The new schedule is part of the SAP Working Group's project on disclosures of related parties, including those for which an insurance entity has received a disclaimer of control or affiliation.

- Add definitions for certain specialty lines of business of P/C insurers including occupational accident, fiduciary liability, premises and operations, and professional errors and omissions. (2020-34BWG)

- Add a new Health Care Receivables Supplement to the Life annual statement, which is Exhibit 3 and 3A from the Health annual statement. (2020-32BWG)

- Modify the annual statement line descriptions used in the Underwriting and Investment Exhibits, State Page and Insurance Expense Exhibit in the P/C blank. (2020-33BWG)

- Revise the Accident and Health Policy Experience Exhibit filed by Life, P/C and Health entities and change the due date from April 1 to March 1. (2020-38BWG)

Financial Regulation and Accreditation Committee

The committee met as part of the Spring National Meeting and exposed the 2020 revisions to the Insurance Holding Company System Regulatory Act (#440) and Model Regulation (#450) for public comment with the recommendation that the revisions be effective for all states as of January 1, 2026. The revisions implement the recently adopted Group Capital Calculation for the purpose of group solvency supervision and the Liquidity Stress Test for macroprudential surveillance. As noted in discussion of the GCC and LST throughout the process to develop those initiatives, certain regulators have expressed concern over the broad application of the GCC to all U.S. insurance holding company systems, with the view the filings should be limited to those groups with international operations. There are also concerns related to the timing of adoption of the initiatives and the ability of states to adopt in accordance with the proposed effective dates. However, the committee approved the resolution and exposed the revisions for comment.

Principles-based reserving

Valuation Manual amendments
During LATF calls held in the first quarter of 2021 several APFs were discussed, exposed and/or adopted, the most notable being the following:

Adopted guidance
APF 2020-11 allows the Life PBR exemption criteria to apply to policies from prior issue years as if the current VM requirements had been in effect during those issue years, without requiring state regulators to grant permitted practice for such use.

APF 2020-13 revises the VM-20 starting asset collar parameters to correctly apply the collar to a modeled reserve that is negative.

Exposed guidance
APF 2020-10 proposed changes would allow application of a prudent assumption for mortality improvement beyond the valuation date, to begin with the 2022 Valuation Manual. See the next section for further details.

APF 2020-12 proposed changes create consistency between clearly defined hedging strategy (CDHS) requirements in VM-20, Requirements for Principle-Based Reserves for Life Products, and VM-21, Requirements for Principle-Based Reserves for Variable Annuities, and revises hedge modeling to only require CDHS if modeling future hedging reduces the reserves under VM-20 or total asset requirement (TAR) under VM-21. The changes include consolidation of the requirements into the VM-01 definition of CDHS and introduction of the term “seasoned hedging strategy” which is intended to prevent companies from avoiding CDHS requirements.

Future exposure
APF 2019-33 proposes revisions to clarify that group life contracts with individual life certificates meeting certain requirements are included in the requirements of VM-20. LATF discussion this spring focused on suggested clarifications received during the most recent comment period. The Academy Life Reserves Work Group drafted the APF and agreed to make the necessary clarifications, but a timeframe for re-exposure was not provided. Proposed changes would be applicable to policies issued on or after January 1, 2024.

Future mortality improvement assumption
At the Spring National Meeting LATF members discussed APF 2020-10 which proposes changes that would allow application of a prudent assumption for mortality improvement beyond the valuation date, beginning with the 2022 VM. The proposal was jointly drafted by the NAIC, industry, regulators and the SOA on the basis that the current VM requirements are beyond moderately adverse with regard to future mortality improvement when significant future mortality improvement is expected. With the reflection of future mortality improvement in the mortality assumption, the interim ½ cx approach to YRT is considered a reasonable long-term approach.

LATF members heard a joint presentation from the Mortality Improvements Life Working Group of the Academy Life Experience Committee and the SOA Preferred Mortality Project Oversight Group outlining the framework for development of both basic and loaded future mortality improvement scales. The proposed framework would allow adjustments for future mortality improvement to be applied for up to 20 years beyond the valuations date, with maximum improvement factors determined by the SOA, adopted by LATF and published on the SOA website by September of each year for use in that calendar year-end valuation.

During the presentation LATF members questioned how the framework would apply when there is a deterioration in mortality improvement and noted the importance of understanding how much reserves may be reduced from application of future mortality improvement. LATF members voted to expose the APF for comment until May 25.

Other VM project updates

YRT reserve credit field test

During an interim call, LATF members discussed comments on the "Criteria to Assess VM-20 Solutions for Modeling Non-Guaranteed YRT Reinsurance," which lists potential criteria for regulators to consider as they determine a long-term solution for the appropriate YRT reinsurance reserve credit for agreements subject to a principle-based reserve. No further action was taken on this matter.

Experience reporting

LATF heard an update from the Experience Reporting Subgroup regarding the mortality experience data collection project. Following the one-year delay in the data call due to COVID-19 disruptions, the data call is set to begin during the second quarter of 2021 and will require data for both the 2018 and 2019 observation years. Data submissions for both years are expected from 129 companies representing 90% of industry claims and will be due by September 30.

VM-22 - PBR for fixed annuities

LATF heard an update from the VM-22 Subgroup on activities related to fixed annuity PBR. During the first quarter of 2021 the subgroup held seven calls to discuss comments received on the Academy Annuity Reserves Work Group (ARWG) proposed framework, "Preliminary Framework Elements for Fixed Annuity PBR." Primary areas of focus are aggregation considerations, use of a standard projection amount as a reserve floor or only for disclosure purposes, and provisions for exclusion testing. In a key vote in March the subgroup voted to retain separate reserve categories for deferred and income annuities, although comment letters supported full aggregation. This was a heavily debated item which concluded with a 6-4 vote in favor of the two categories.

Exposure of VM-22 PBR requirements is targeted for mid-summer 2021, a field test is targeted for February 2022 through June 2022, and the target date for implementation is now January 1, 2024.

Life Actuarial Task Force

Standard Nonforfeiture Law for Life Insurance

During the interim period LATF members discussed the implications to life insurers from changes in the maximum life insurance nonforfeiture interest rate for policies with guarantees of greater than 20 years resulting from revisions to Section 7702 of the Internal Revenue Code included in the Consolidated Appropriations Act of 2021. The change lowers the maximum nonforfeiture interest rate to 3.75% for guarantee durations greater than 20 years, and regulators are poised for a surge in product filings to reflect the lower nonforfeiture rate. While the Standard Nonforfeiture Law for Life Insurance (#808) provides for a 12-month implementation period, the ACLI raised concerns to LATF about marketing issues that may arise if companies are unable to get policy filings approved that reflect the lower nonforfeiture rate before the end of 2021. The ACLI will consider potential next steps including raising the matter to the Life Insurance and Annuities Committee and any solutions available through amendments to the Valuation Manual.

ESG implementation project

During the interim period and at the Spring National Meetings LATF discussions were heavily devoted to the economic scenario generator (ESG) project. (For life actuarial purposes, the ESG is used to develop economic scenarios for life and annuity statutory reserves and capital calculations.) Conning & Company is the ESG vendor selected by the NAIC to replace the Academy. Following the Fall National Meeting the "Initial ESG Recommendation" was exposed for an extended comment period through March 22.

Supporting documents are available on the "Related Documents" tab of the LATF webpage, and a link to information on the Conning site is available in the PBR Section on the Industry tab of the NAIC's Website. The available information includes treasury, equity and corporate scenarios and related documentation, a Q&A document developed by NAIC staff to capture and respond to questions submitted by industry members, and recordings from calls with Conning to address questions on the ESG models. Over 20 companies have volunteered to participate in a field test targeted for June through August. Adoption of ESG-related VM amendments is targeted for the Fall National Meeting to be effective January 1, 2022. However, some regulators and industry representatives have expressed concern over the aggressive timeline, which seems likely to be delayed, allowing more time for consideration of the information and emerging questions.

Discussion at the Spring National Meeting focused on themes in the comment letters and the corresponding regulator responses. Comments were received from 15 interested parties, the ACLI, the Academy Economic Scenarios Work Group (ESWG) and regulators. Several commenters, including the

Academy ESWG, expressed concern over the absence of full documentation of the ESG specifications, prompting a statement from LATF noting a "commitment to releasing an appropriate level of documentation to facilitate understanding of the new ESG while recognizing Conning's intellectual property rights." Another common theme in the comments is concern over extreme results in the scenario basic data set, questioning whether the resulting scenarios are reasonable, highlighting the need for appropriate calibration of the scenarios as well as additional documentation to better understand the results. To date over 75 questions and responses have been recorded in the Q&A document.

Long-term care issues

The newly formed Long-Term Care Insurance Model Update Subgroup held its first public meeting in April. The primary charge of the subgroup is to review and update the LTC Model Law and Regulation (#640 and #641) to determine their flexibility to remain compatible with the evolving delivery of LTC services and the evolving LTCI marketplaces. The Limited LTC Model Law and Regulation (#642 and #643) will be updated to be consistent with any revisions to #640 and #641. The chair of the subgroup noted that they will not be proposing revisions to specific models but will be only identifying whether changes are necessary. No timeframe for completion was discussed.

Life insurance and annuity committee

During the Spring National meeting, the committee discussed issues related to life insurance practices pertinent to COVID-19. The Consumer Federation of America has asked the committee to consider developing a model rule to address underwriting standards for life insurance contracts in this pandemic era, primarily questions about negative virus tests and vaccination status, and making the standards more transparent to consumers. The discussion included comments that the Interstate Insurance Product Regulation Commission's (Compact) Uniform Standards do not allow direct COVID-19 testing questions but do allow other types of medical diagnosis or treatment questions that could provide that information.

The committee also discussed the issue of denying payments if the cause of death was the COVID-19 vaccination (which is a false rumor that several regulators are aware has been circulating). The committee reiterated that the Uniform Standards prohibit including an exclusion for death from a specified condition and that vaccinations do not affect life insurance benefits. Discussions on this topic will continue. The committee also noted that the Insurance Compact has created a COVID-19 FAQ.

Annuity suitability

Following the adoption of the revised Suitability in Annuity Transactions Model Regulation (#275) in February 2020, states have begun the process of adopting the new regulation. To assist state regulators with informing their legislators about the revisions, the Annuity Suitability Working Group has exposed an FAQ document, which will promote greater uniformity across NAIC member jurisdictions. When the working group met at the Spring National Meeting, they continued to discuss comments on the FAQ including consideration of adding additional questions. The next meeting is early May where they hope to complete their work.

International Insurance Relations Committee

The committee heard an update on projects in process.

IAIS update

The International Association of Insurance Supervisors completed its annual global monitoring exercises as part of the implementation of the Holistic Framework last fall and issued the 2020 Global Insurance Market Report. The IAIS will continue to monitor how the insurance sector is affected by COVID-19 and is also discussing activities and priorities related to climate risk and sustainability.

The IAIS is also performing an implementation assessment of the Holistic Framework which is being done in phases and will inform the Financial Stability Board's review of the effectiveness of the framework in 2022. The first phase, baseline assessment, has been finalized and second phase, jurisdictional assessment, has commenced; the U.S. is participating in the second phase.

The IAIS completed and exposed last fall a draft application paper on the Supervision of Climate-related Risks in the Insurance Sector that the International Insurance Relations Committee previously commented on and is expected to be published before the IAIS's June meeting.

The IAIS also previously released a draft high-level principles document for assessing comparability of the U.S.-developed Aggregation Method to the Insurance Capital Standard, Aggregation Method: Draft Level 1 Document. At the Spring National meeting, the committee discussed comments received and the plan to develop criteria, with an exposure draft for comment by year-end.

The International Insurance Relations Committee reviewed and provided comments on the IAIS draft application paper on Supervision of Control Functions (specifically ICP 8, Risk Management and Control Functions, ICP 5, Suitability of Persons and ICP 7, Corporate Governance), and provided comments on the IAIS draft application paper on Resolution Powers and Planning which were mostly editorial. The committee also provided comments on the IAIS draft application paper Development of Liquidity Measures related to the broader Holistic Framework for systemic risk. Comments were generally supportive of the proposed approach but suggested further historical analysis or sensitivity analysis in certain areas.

At the Spring National Meeting, the committee heard a presentation from the American Academy of Actuaries on its work related to the use of scalar methodologies, (used to translate required capital from non U.S. jurisdictions to make them comparable to U.S. entities in their group) in the NAIC's group capital standard. The AAA did not provide any recommendations but provided considerations related to the use of various methods.

Climate risk

During the Spring National Meeting, the Climate Risk and Resilience Task Force received and approved a recommendation from its Climate Risk Disclosure Workstream on the status of the current NAIC Climate Risk Disclosure Survey. Noting that many federal and international regulatory agencies are also reviewing the need for climate risk disclosures, the Disclosure Workstream is aiming to promote consistency in reporting, where practicable. The Workstream recommended to the task force that the 2021 reporting framework remain consistent with the 2020 reporting requirements. (Beginning in 2020, insurers could file either the NAIC Climate Survey or the Task Force for Climate-Related Financial Disclosures (TCFD).) The Disclosure Workstream noted that with the annual NAIC climate survey launch upcoming in July, it simply did not feel there was enough time to make additional changes for the 2021 cycle.

Currently, only six states require certain insurers to participate in the NAIC Climate Survey program: California, Connecticut, Minnesota, New Mexico, New York and Washington. However, since all licensed insurers with $100 million or more in premiums in the participating states file the climate survey, more than 70% of the U.S. insurance market currently is represented; the workstream is now encouraging more states to require climate risk disclosures. The overall goal is robust and consistent disclosures across the insurance sector.

During its Spring National Meeting, the task force noted that regulatory pressure and action is potentially forthcoming, driven by the climate-related goals of the Biden administration, which recently issued a draft executive order titled "Climate-Related Financial Risk," outlining a federal government strategy to identify and disclose climate risks. Included within the order are instructions impacting multiple organizations including the Financial Stability Oversight Council and the Federal Insurance Office. Both organizations are likely to be instructed to examine the climate-related risks of their member industries, which include insurers. Details have not been finalized, but it is thought that the executive order could lead to enhanced disclosure requirements by insurers, including identification of exposure to fossil fuels and impact of climate changes on insurance coverages. The SEC and the Federal Reserve are also considering enhanced disclosures from the financial services sector including insurers; all these developments will be monitored by the task force.

P/C rate filing reviews

At the Spring National Meeting, the Casualty Actuarial Task Force heard an update on the NAIC's rate model review program, officially known as the "Rate Review Support Services Agreement." The agreement, which has been signed by 28 states thus far, allows state regulators access to a shared model database as well as the ability to request that NAIC staff conduct a review of a P&C rate model on behalf of a state. The reviews, which do not allow the NAIC to assume any regulator authority, can provide information on actuarial/statistical errors or missing documentation in the rate models. To date NAIC assistance has been used in 31 filings, and the volume of requests is increasing.

Mortgage guaranty insurance issues

The Mortgage Guaranty Issues Working Group had exposed for comment a draft Mortgage Guaranty Insurance Exhibit (Schedule MG), which goal is to address the current "limited data captured for mortgage guaranty insurance." The mortgage guaranty industry consortium provided comments on proposal, focusing on potential confidentiality questions, as well as proposals to modify the time period of data requested due to issues obtaining certain past data. As a result, the working group expects to implement several changes to the draft and re-expose it for comment at a future meeting; the regulators hope to implement the new exhibit for year-end 2021.

An update on the status of the State Regulatory Mortgage Insurance Capital Model is scheduled for a meeting on May 18.

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The 2021 Summer National Meeting of the NAIC is scheduled for August 14-17, with parent level committee meetings possibly in person in Columbus, Ohio. We welcome your comments regarding issues raised in this newsletter. Please provide your comments or email address changes to your PwC LLP engagement team, or directly to the NAIC Meeting Notes editor at jean.connolly@pwc.com.

Appendix A

This table summarizes actions taken by the SAP Working Group since January 2021 on open agenda items. For full proposals exposed and other documents, see the SAP Working Group webpage.

Issue/ Reference #	Status	Action Taken/Discussion	Proposed Effective Date
ASU 2016-13 – Credit Losses (#2016-20)	Discussion deferred	In 2019, the SAP Working Group asked NAIC staff to continue monitoring implementation of ASU 2016-13 after the FASB extended the effective date until 2023 for all entities except large SEC filers. The regulators may resume consideration of the statutory other-than-temporary impairment methodology for available-for-sale bonds in late 2021 or 2022.	TBD
SSAP 86 – ASU 2017-12, Derivatives and Hedging (#2017-33)	Discussion deferred	This project will review the overall accounting and reporting changes required by this ASU as potential substantive revisions to SSAP 86. NAIC staff expects discussion to resume in later 2021 or 2022.	TBD
SSAPs 68 & 97 – ASU 2014-17, Pushdown Accounting (#2019-12) and SSAPs 68 & 97 – Goodwill (#2019-14)	Discussion deferred	Discussion of goodwill issues has been deferred due to COVID-related accounting issues in 2020. During its Fall National Meeting, NAIC staff proposed a project to "holistically review the business combinations and goodwill guidance" in SSAP 68. Once that is approved by SAPWG, these agenda items are expected to be addressed in that project. There was no discussion of goodwill at 2021 Spring National Meeting.	TBD
SSAP 43R – Revised Issue Paper (#2019-21)	Exposure draft expected in May	A small group of industry, regulators and NAIC staff working on updating bond definitions has made significant progress and a public exposure is expected May 20. See further discussion above on page 4.	TBD
SSAP 71 – Commission Financing (#2019-24)	Adopted	The SAP Working Group adopted proposed revisions to SSAP 71 to prevent insurers from deferring the recognition of commission expense using "financing transactions." Adoption in March by the working group was confirmed by both the APP Task Force and the Financial Condition Committee at their meetings this spring. Final adoption of this contentious issue by Executive Committee and Plenary will be discussed during a special interim meeting or at the Summer National Meeting.	December 31, 2021
SSAP 25 – Related Parties, Disclaimers of Affiliation and Variable Interest Entities (#2019-34)	Adopted	The working group adopted a proposal to clarify the identification of and disclosures required for related parties with a disclaimer of control or affiliation. The revisions also include a new disclosure to capture related party information, which will be accomplished through a new schedule, Schedule Y, Part 3. See further discussion above in the summary of the SAP Working Group (page 4).	January 1, 2021

SSAP 62R – Retroactive Reinsurance Exception (#2019-49)	Discussion deferred	The regulators have been asked to address inconsistencies in application of the retroactive reinsurance accounting and reporting guidance, especially with respect to Schedule P reporting. After discussion with the Casualty Actuarial Task Force, NAIC staff's preliminary recommendation is that the premium and losses transferred under such transactions should be allocated to the prior Schedule P calendar year premiums and the losses allocated to the prior accident year incurred losses. A formal exposure is expected later this year.	TBD
SSAP 26R – Perpetual Bonds (#2020-22)	Adopted	The working group adopted the proposed revisions to clarify language that perpetual bonds with call features should apply the yield-to-worst amortization concept and be reported at amortized cost. Perpetual bonds without call features are to be reported at fair value. See further discussion above in the summary of the SAP Working Group.	January 1, 2021
INT 20-11 – Extension of 90-Day Rule	Adopted	The SAP Working Group adopted a 60-day extension for the 90-day rule for uncollected premium balances, bills receivable, and amounts due from agents and for policies directly impacted by the noted events (2020 Hurricanes, California Wildfires and Iowa Windstorms). This INT expired February 28, 2021.	January 1, 2021
SSAPs 53, 54R & 66 – Policyholder refunds (#2020-30)	Discussion Deferred	The regulators previously requested input from industry on whether additional guidance is necessary related to discretionary policyholder refunds and other premium adjustments for heath and P/C lines of business. Based on feedback, the working group directed NAIC staff to draft a future agenda item to propose additional guidance, including for group health premiums and premium adjustments as the result of newer policy form types, such as those involving data telematics.	TBD
SSAP 26R – Disclosure update (#2020-32)	Adopted	The SAPWG adopted non-substantive revisions to expand the called-bond disclosures in SSAP 26R to include bonds terminated through a tender offer.	January 1, 2021
SSAP 32R – Preferred stock warrants (#2020-33)	Adopted	The regulators adopted non-substantive revisions to capture publicly traded preferred stock warrants in SSAP 32R (and not in SSAP 86, Derivatives) and specified that warrants shall be reported at fair value.	January 1, 2021
SSAP 43R – GSE CRT Program (#2020-34)	Adopted	The SAPWG adopted revisions to SSAP 43R to incorporate modifications reflecting recent changes to the Freddie Mac Structured Agency Credit Risk (STACR) and Fannie Mae CT. Avenue Securities (CAS) programs, which allow credit risk transfer securities from these programs to remain in scope of SSAP 43R when issued through a REMIC structure.	January 1, 2021

Appendix A

SSAP 97 – Audit Opinions (#2020-35)	Disposed	The SAP Working Group had previously requested comments on the prevalence of situations in which SSAP 97, par. 8.b.iii. entities (U.S. and foreign non-insurance U.S. GAAP basis SCAs) are not admitted by the parent insurer due to the inability to quantify the departure(s) from U.S. GAAP. As this issue was deemed uncommon, this item was disposed without statutory revisions.	N/A
SSAPs 86 & 108 – Derivatives Hedging Fixed Indexed Products (#2020-36)	Re-exposed	The working group re-exposed this item to provide additional time for interested parties to develop a proposal for establishing accounting and reporting guidance for derivatives hedging the growth in interest for fixed indexed products.	TBD
SSAP 56 – Separate Accounts (#2020-37) and Pension Risk Transfers (#2020-38)	Re-exposed	The SAP Working Group combined these two proposals and re-exposed them for concurrent exposure with a Blanks Working Group (2021-03BWG) proposal, which would modify the current General Interrogatory instructions and require that a distinct product identifier be used for certain separate account products, i.e. pension risk transfer group annuities, all other group annuities and registered index-linked individual annuities. This proposed disclosure is in response to the recent growth of pension risk transfer transactions.	December 31, 2021 annual statements
Appendix F – Interpretation Policy Statement (#2020-39)	Adopted	The working group adopted revisions to clarify the issuance and adoption process of accounting interpretations (INTs). The revisions would require a two-thirds majority of the full Accounting Practices and Procedures Task Force to "overturn, amend or defer" a decision made by the SAP Working Group, or a simple majority of the Financial Condition Committee. These changes are proposed in response to issues related to the adoption of INT 02-08 on COVID premium refunds.	January 1, 2021
Preamble – Prescribed Practices (#2020-40)	Adopted	The SAP Working Group adopted revisions to clarify that while any state in which a company is licensed can issue prescribed practices, the prescribed practices directed by the domiciliary state shall be reflected in the financial statements filed with the NAIC, and these are the financial statements subject to the independent auditor requirements.	January 1, 2021
SSAPs 5R, 72, & 86 Convertible Instruments (#2020-41)	Adopted	The SAP Working Group adopted revisions to reject ASU 2020-06, Convertible Instruments. This ASU primarily addresses various convertible debt valuation models along with bifurcating embedded derivative components, which are not concepts supported by statutory accounting.	January 1, 2021
Appendix D – Not-for-Profit Entities (#2020-42)	Adopted	The working group adopted the rejection of ASU 2020-07, Presentation and Disclosures by Not-for-Profit Entities as not applicable to statutory accounting.	January 1, 2021

Appendix A

INT 20-03 and INT 20-07 Guidance Extensions	Adopted	The SAP Working Group adopted previously exposed revisions to extend the effective date of TDR relief guidance until January 1, 2022 (or the date that is 60 days after the date on which the COVID-19 national emergency ends).	January 1, 2021
SSAP 86 – Reference Rate Reform (#2021-01)	Exposed	The SAP Working Group exposed revisions for a temporary (optional) expedient and exception guidance for ASU 2021-01, Reference Rate Reform (Topic 848): Scope with an expiration date of December 31, 2022. The optional expedients would expand the current exceptions provided by INT 20- 01: ASU 2020-04 – Reference Rate Reform. See discussion in the SAPWG summary on page 4.	TBD
SSAP 26R – Receivables (#2021-02)	Exposed	The Working Group exposed a proposal to reject ASU 2020-08, Codification Improvements to Subtopic 310-20, Receivables–Nonrefundable Fees and Other Costs for statutory accounting.	TBD
SSAP 103R – Transfers of Assets (#2021-03)	Exposed	The SAP Working Group exposed a proposal for new disclosure elements and a data-capture template for certain existing disclosures in SSAP 103R. A blanks proposal has also been concurrently exposed.	TBD
SSAP 97 – Investments in Subsidiaries (#2021-04)	Exposed	The SAP Working Group exposed this item with the intent to dispose without statutory edits. Industry is requested to submit comments on any prevalent examples of a negative equity valuation in a foreign insurance subsidiary, controlled or affiliated (SCA) investment with detailed information for assessment.	TBD
SSAP 2R – Cash & Cash Equivalents (#2021-05)	Exposed	The regulators exposed for comment clarifications that cryptocurrencies do not meet the definition for cash and are nonadmitted assets for statutory accounting. See additional discussion om page 4.	TBD
Appendix D – (#2021-07)	Exposed	The working group exposed revisions to reject ASU 2020-11, Financial Services—Insurance: Effective Date and Early Application for statutory accounting.	TBD
SSAP 47 – Uninsured Plans (#2021-08)	Exposed	The regulators exposed a proposal to reject ASU 2021-02, Franchisors – Revenue from Contracts with Customers.	TBD
SSAP 107 – Affordable Care Act (#2021-09)	Exposed	SAPWG exposed revisions related to State ACA reinsurance programs, which are using Section 1332 waivers, in scope of SSAP 107. Proposed guidance directs health entities to follow the hybrid accounting approach for the state ACA programs as they operate in a similar manner as the prior federal reinsurance program. See discussion in the SAPWG summary above.	TBD

Appendix B

This chart summarizes recent action on other proposals of the RBC Working Groups, i.e. those not discussed on pages 5-7 of this Newsletter. The detail of all proposals adopted for 2021 RBC are posted to the Capital Adequacy Task Force's webpage.

RBC Formula	Action taken/discussion	Effective Date/ Proposed Effective Date
All/multiple formulas		
Managed Care Credit Incentives (2021-02-CA)	The Capital Adequacy Task Force **adopted** proposed revisions to clarify that both incentives and bonuses paid to providers are to be included in the managed care credit calculation. The current managed care instructions reference only bonuses.	2021 RBC Filings
Health and P/C Bond Structure (2020-10-CA)	The Capital Adequacy Task Force **adopted** the bond structure in the health and P/C RBC formula pages to extract the information from the footnotes of Schedule D, Part 1; Schedule DA, Part 1; and Schedule E, Part 2 "for greater consistency and transparency in the RBC reporting."	2021 RBC Filings
Receivables for Securities (2021-07-CA)	The Capital Adequacy Task Force **exposed** for comment proposed revisions to the three formulas to update the receivables for securities factor for Life (from .014 to .015), P/C (from .025 to .020) and Health (from .025 to .024)	2021 RBC Filings
P/C RBC	Action taken/discussion	Effective Date/ Proposed Effective Date
Catastrophe Risk Interrogatories (2020-08-CR)	The Catastrophe Risk Subgroup **adopted** new instructions to clarify how insurers with no gross exposure to earthquake or hurricane should complete the Interrogatories.	2021 RBC Filings
Remove Operational Risk Factor from Rcat (2020-11-CR)	The Catastrophe Risk Subgroup **adopted** a proposal to remove the embedded 3% operational risk charge in the Rcat component because the P/C RBC formula now has a stand-alone capital add-on for operational risk.	2021 RBC Filings
Credit Risk Instruction Modification (2021-03-P)	The P/C RBC Working Group **adopted** a proposal to provide examples to clarify how reporting companies should select the designation for Schedule F, Part 3, Reinsurer Designation Equivalent Rating column if the insurer has ratings from one or multiple rating agencies.	2021 RBC Filings

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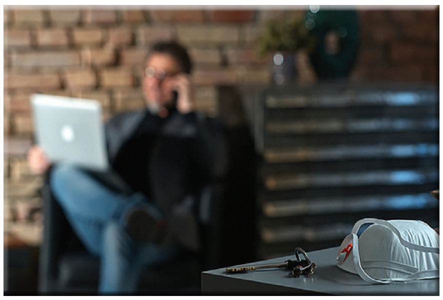

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