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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 issue 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 to be made available. In other words, there will only be tests available for credit for four quarters at any given time.

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The questions are on the following page. Good luck!

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CRE Reading Program Questions

All quizzes MUST be taken online.

Questions will be ***available online October 26, 2021.***

Conducting Examinations in the "New Normal"

Multiple Choice Questions — Submit Answers Online

1. The author(s) suggest that Examiners could gain potential efficiencies through timely communication in a number of areas. Which of the following is not one of the areas the author(s) suggest?
   a. Kick Off Meeting
   b. Work Schedule
   c. Multiple Contact Persons
   d. Face to Face Meetings

2. When requesting and reviewing external auditor workpapers, the Examiners should receive workpapers in original format because:
   a. It will take longer for the CPAs to convert all the workpapers to PDFs and an examination team needs to receive these workpapers quickly.
   b. Original format helps when relying on work as the examiner can see more detail and allows the examiners to manipulate [notate] the workpapers.
   c. PDFs are required to be imported to TeamMate as TeamImage files which makes it hard for the Examiner to review the pages quickly.
   d. The Examiners should not worry about original format, PDFs of the Audit File workpapers is the preferred format for an examination team.

3. When considering our approach to Phase 3 in the "new normal" all of the following should be evaluated by the EIC / Exam Team, except:
   a. Consider key risk area meetings, consider conducting these earlier in your Phase 3 process for smaller companies and after review of control documentation maintained by larger companies
   b. Be careful when deciding the level of reliance to place on external auditor control testing as external auditors may have a different focus than an exam in relation to mitigation strategies.
   c. Examiners should understand the impact of moving from in office to remote work on the controls and processes implemented by the insurer.
   d. In the remote environment Phase 3 – Testing of Controls will be too difficult; therefore, the EIC / Exam Team should just skip to Phase 5 to avoid the frustration.

4. The author(s) suggest avoiding end of day / Friday requests, having written agendas for meetings with the company, and considering specialist meetings with the Company to avoid
   a. Examinations becoming a desk audit.
   b. Receiving fraudulent responses from the company.
   c. Experiencing delays in receiving requested information.
   d. The company contact forgetting an exam is ongoing.

5. All of the following are measures an Examiner should take when using an at home wireless network connection to achieve better security, except:
   a. Use WPA2 or better encryption
   b. Make network name confusing / look fake
   c. Frequently change administrator password
   d. Disable guest access

A Guide to Leveraging Economic Capital to Conduct More Effective Exams

Multiple Choice and True or False Questions — Submit Answers Online

6. Which of the following is not one of the capital metrics discussed in the article?
    a. Available Capital
    b. Working Capital
    c. Economic Capital
    d. Deployable Capital

7. Deterministic approaches to stress testing consider a distribution of outcomes from numerous simulations.
    a. True
    b. False

8. Which Security Standard is most widely used in economic capital modeling?
    a. CVaR
    b. VaR
    c. TVaR
    d. AviTaR

9. Which of the following is not a key component of measuring economic capital mentioned in the article?
    a. Accounting Basis
    b. Risk Horizon
    c. Leverage Ratio
    d. Diversification Benefit

10. Perfectly correlated risks provide the maximum diversification benefit in economic capital calculations.
    a. True
    b. False

Captives can be an Insurtech Accelerator

Multiple Choice and True or False Questions — Submit Answers Online

11. Why have insurers had to dramatically cut back on insurtech funding?
    a. Immense financial and operational challenges
    b. The spread of the COVID-19 pandemic
    c. Both (a) & (b)
    d. None of the above

12. What reasons slow down the adoption of insurtech solutions?
    a. Insurers naturally are reluctant to offer premium credits
    b. Insurtech providers have confidence in the efficacy of their products.
    c. Both (a) & (b)
    d. None of the above

13. The "insurable risk" is the risk that losses do not meet the agreed-upon price reduction of the insurer.
    a. True
    b. False

14. The captive solution can be superior for the following reason(s):
    a. Overarching governance framework and control
    b. Independent actuarial estimate of the savings
    c. Tax advantages
    d. All of the above

15. The "three-legged stool" ecosystem includes:
    a. Traditional insurers
    b. Insurtech community
    c. Captives
    d. All of the above

PwC NAIC Newsletter Summer 2021

True or False Questions — Submit Answers Online

16. The Blanks Working Group exposed a proposed revision to add a new supplement to the P/C Annual Statement that would provide expanded information for the "Other Liability" lines of business (Lines 17.1-17.3) in the EXHIBIT OF PREMIUMS AND LOSSES (Statutory Page 14).
    a. True
    b. False

17. The Group Capital Calculation Working Group adopted the requirement that the Group Capital Calculation be performed on all insurers by December 31, 2021.
    a. True
    b. False

18. The Statutory Accounting Principles Working Group adopted a proposed Interpretation that states that cryptocurrencies do not meet the definition of cash and that they should be classified as non-admitted assets.
    a. True
    b. False

19. The Risk-Focused Surveillance Working Group exposed proposed revisions to the Financial Analysis and Financial Examiners Handbooks to provide analysis and examination guidance for the review of affiliated service agreements with market-based expense allocations.
    a. True
    b. False

20. The Statutory Accounting Principles Working Group adopted a revision to SSAP 71 to allow insurers to defer recognition of initial sales commission expense.
    a. True
    b. False

Conducting Examinations in the "new Normal"

By Dan Judge, CFE and Sara Schumacher, CFE, CPA, CPCU, CIE, MCM, ARe
Risk & Regulatory Consulting, LLC

Is there such a thing as a "New Normal" for examinations as we move into a post-COVID-19 world? Likely not given the ongoing changes not just in the work environment but also in new exam requirements, new laws/regulations, development of new technology, and many other factors.

After the last couple of years, it is undeniable that remote examination work is here to stay. The on-site vs. remote debate will continue as we work our way past the pandemic including new variants, vaccination mandates and work to get into a new normal. The remote work concept applies to not just financial examinations but also to market conduct examinations, financial statement audits and to insurance companies' operations.

Much of this article will focus on the remote work as we move into a new normal for examinations. In this article, we will be presenting some best practices and pitfalls to avoid in future examinations.

Communication

One of the biggest challenges faced during the past year has been communication amongst all individuals involved in the exam that may not be accustomed to remote work. Some organizations were ready for the transition or had already been working remote for years, while others have utilized a remote work model since the turn of the millennium. There was still a need for good communication previous to 2020, but the current examination environment has made this even more critical. There has never been a greater need for communication and expectation setting. Examiners could gain potential efficiencies through timely communication in the following areas:

- Kick Off Meeting – This is a great opportunity at the beginning of the examination to set the tone with the Company and examination staff. It is important to use this meeting as a chance to determine points of contact, and whether the Company will be available for on-site fieldwork.

- One Main Contact Person – The Examiners should use one person at the Company as a main point of contact. It is important to not just communicate in writing but also through verbal discussions. Regularly scheduled verbal discussions are useful to address exam status updates with the company. We suggest memorializing these discussions in brief minutes which would document any follow up items. With many taking planned and unexpected time off or not being able to work a regular eight to five schedule, it may be good for everyone to establish a backup contact.

- Work Schedule – Since there is a good chance that exam team members will be located throughout the US, having a range of time for everyone to be online or available can help avoid delays due to time zone differences. Consider discussing this when kicking off the examination. It is also good to gain an understanding of everyone's schedule including the exam contact at the company and at the department.

There are some that may work a standard 8AM – 5PM every week and others may be on a flex schedule.

- Questions – Don't be shy about asking questions. It is good to use status update calls and kick off meetings to address logistics. It also good to consider asking instead of assuming.

- Potential Issues – It is important to communicate any potential issues timely to the main exam contact. This allows time for the company to respond to potential issues and maybe even time to implement a corrective action plan.

- Regular Check-ins – The Examiner-in-Charge should conduct regular check-ins with examination staff, either scheduled or ad-hoc, similar to how regular conversation would occur in an onsite exam. This will provide the opportunity for sharing of information, asking questions that otherwise may not be asked, and keeping a good pulse on the status of the exam.

- Mentoring and On-the-job Training for New Staff – One of the most significant challenges will be how to train new staff in a remote environment. There should be daily substantive contact with the new staff. Using screen sharing while having these conversations will assist with the new staff's learning process.

- Face to Face Meetings – Exam teams and departments will need to adapt to having face to face meetings utilizing Zoom, WebEx, Microsoft Teams or other virtual options rather than just voice calls. This face-to-face communication is invaluable to fostering communication and can help cut back on in on-site work through share screen and other features. It is also good to not have every call using Zoom or other virtual option as this can cause fatigue if used too much for individuals. Be mindful of how often you are utilizing this option and make sure everyone can utilize the format used.

C Level Interviews and other info meetings

While some C-Level interviews were conducted remotely in the past, a vast majority were completed this way in 2020 and through 2021. Technology has increased so that there are more options than just conference calls. Video conferencing through Skype, Zoom, WebEx and Microsoft Teams are all viable solutions. It is important that video options be used for the C-Level interviews. This not only gives you the chance to see the executives, but also them a chance to see you. A best practice is to ask what video conferencing services the Company prefers to use. For simplicity, using a system provided by the Company might make it easier for them to participate. Examiners should familiarize themselves with different video conferencing software and test the systems before interviews start. This will help prevent technical issues when the live interviews start.

C-Level interviews are also a great time to discuss what potential risks the Company has noted internally. While Examiners are usually focused on financial solvency risks, this might be a good opportunity to ask about cyber risks, the company's new normal, adoption of new technology, adoption of big data, or other changes. Examiners should focus their C-Level interviews and avoid conducting an excessive number of interviews. Focus on the most important or highly involved C-Level executives such as but not limited to the Chief Executive Officer, Chief Risk Officer, Chief Information Officer, heads of underwriting and claims, and Chief Financial Officer.

Reliance on External Auditor Work

As directed in the National Association of Insurance Commissioners (NAIC) Financial Condition Examiner Handbook (FCEH), Examiners are to assess and to rely on the external auditor's work as much as possible in order to reduce duplication of the same work in the financial examinations. In addition, the department analyst also relies upon external auditor work annually to provide assurance of the financial condition being reported by the company in their annual statements.

External Auditor Appointment and Initial Assessment

Given the increased level of reliance on the external auditor, it is important for departments to consider if external auditors are qualified when appointed and that the company properly reports the change in external auditor to the department. Following are some items for the analyst to consider when there is a change to the external auditor:

1) Are they qualified (i.e., must be licensed as CPA firm);
   Do they have experience with conducting statutory insurance audits, and;

2) Are there any reputational issues? It is important for analysts to be aware if an external auditor was found to not be reliable on other exams and/or if become aware of any compliance or other issues noted by state license board, recent AICPA review of the firm and/or news alerts of litigation settlements, cyber breach or other. There likely is already a process that each state departments follows to report these issues and to keep abreast of these issues when noted. If not, then likely Chief Examiner and Chief Analyst should be informed of any audit firm issues so can identify applicability to any other companies domiciled in the state and to take appropriate action.

3) Lastly, an analyst should not forget to review the prior external auditor letter on if any issues department should be aware of for the change in auditor.

This monitoring is important to be conducted given likely limited on-site work and due to the extensive reliance on external auditors to test financial statements and related financial risks.

Examiner Assessment of the External Auditor

During the examination, Examiners must assess the adequacy of the external auditors' work and ability to rely on the external auditor during the examination. Per the NAIC FCEH and guidance from the NAIC, Examiners should document their assessment through completion of Exhibit E (including a memo on overall assessment and planned level of reliance), meeting with the external auditor, and review of the audit workpapers including completion of a memorandum on the workpapers reviewed, issues noted during the review of the workpapers, if any accounts/areas of the financial statements were not tested and/or adequacy of sample sizes. Following are some items Examiners should consider completing during upcoming examinations in the new normal:

- It is important for Examiners to ensure the above items have been reviewed by the department (i.e., were appointed, the department was notified of the new auditor, if external auditor has expertise to complete an audit of an insurance company and there are no reputation issues to consider). Examiner can complete these steps through reliance on the analyst work (review of the analyst workpapers, communications with the departments and inquiry during the meeting(s) with the Analyst and Chief Examiner). If analyst is not aware of any issues, it may be good for the Examiners to consider if they have become aware of any issues through their prior experience with the auditor or during review in the current examination. If Examiners become aware of an issue, it is also important for immediate communication with the department of any issues noted.

- When requesting and reviewing the external auditor workpapers, it is important to receive all external audit workpapers in their original format when possible. The original format helps when relying on testing of controls and/or substantive testing as the examiner can usually see more details. When workpapers are rendered into PDF from original format, then can sometimes lose info and/or be difficult to review. The Examiner can also manipulate these workpapers when in original format to easier link to other workpapers referenced.

- It is helpful to receive an audit workpaper listing with names, workpaper numbers, project organization structure and original format type. This can significantly reduce the back-and-forth communication with external auditor and help ensure receive all workpapers. From personal experience, this has cut down total hours to review the external auditor's work significantly especially when issues popped up like workpapers are in a certain format that had issues when being re-formatted to another like Word, Excel or PDF, can let Examiners know right away if workpapers are missing and/or can help when a workpaper may reference into another like by name rather than number etc.

Many firms are on their second year of conducting the external audit of companies remotely. While many firms are beginning to move to working back in the office, many of the firms are moving to work fully remote or to work remotely whenever possible. Firms seem to be moving to this model to recruit/retain staff, to cut office costs and various other factors. There are some that are not moving to remote work environment due to their firm's culture. If you read accounting and/or auditing journals, you will notice many articles concern the topic of remote work like best practices consider when working remotely, how to compete in virtual environment or how to adapt human resources and/or firm culture to remote work. Given the new remote model for external auditors, the following should be considered by Examiners in upcoming examinations when assessing the external auditor, reliance on external auditor work and/or examination plan:

- As part of the external auditor meeting, Examiners should consider discussing the level of remote work conducted by external auditors and if there were any issues noted when conducting remote testing. It would be good to discuss in detail how the fraud inquiries were conducted, the control walkthroughs completed, any control testing completed, and substantive testing completed. For example, if work performed off-site, was some type of video conference or share screen feature was utilized. If the external auditors noted any issues conducting off-site work, these should be considered when completing Exhibit G Fraud Risk Factors, Assessment of External Auditor, Planning Level of Reliance on External Auditor, Risk Assessment in Phase 2 and examination testing plan for Phase 3 and 5.

- When reviewing workpapers, Examiners should be on alert for too much reliance on prior year audit work. This may be a risk area that Examiners do not want to fully rely on that work during the exam. For instance, maybe the auditors did not discuss a significant reinsurance agreement entered into during 2020 and therefore was not tested or maybe their control testing/walkthroughs were last conducted in 2018 and may need to be updated. Insurance companies moved to a largely remote work model overnight in early 2020. The external auditors would be expected to assess and document impact of insurance company employees working remotely on internal controls.

- It is important for Examiners to review any control walkthrough and/or testing to see when it was last conducted and/or if this has been updated for changes to the company's operations in the new normal. If these have not been updated recently and/or appear to not be updated for changes to the company since the new normal, then Examiners may want to focus on getting these updated during the examination. The best method is likely through setting up a special meeting(s). For example, Examiner may meet with claims manager to update the walkthroughs and key controls.

- Lastly, Examiners should be on the lookout for lack of testing for key accounts and/or if the testing performed may not be sufficient. Many firms may begin to move to rely significantly on analytical testing, may raise materiality to cut down on testing and/or may limit testing we expect. For example, rather than reconcile data from a policyholder system to the accounting system and detail test premiums or claims, the external auditor may decide to rely on the Company completing a reasonableness check and conducting substantive testing. As this is a critical risk area in examinations, Examiners may need to consider conducting this testing.

Now more than ever, Examiner's work conducted to determine the assessment and reliance on external auditors is gaining critical importance. This work can significantly impact the financial examination plan and budget. As we begin to notice these issues, it is important to communicate them immediately to the department and for Examiners to begin to track what external audit firms will be changing in their new normal.

Attention should be paid to Phase 3 – Test of Controls

With examination work being performed remotely, it important for Examiners to pay close attention to phase 3 or test of controls. This has been an area identified for improvement in many peer reviews completed and poses an increased risk for deficiency in the remote exam environment.

Over the last year, Examiners may have been primarily focused on gaining an understanding of changes to an insurers controls and completing limited testing as a result of limitations due to the pandemic or deciding it was more efficient and effective to move straight to Phase 5. Going forward, Examiners will need to come up with a game plan to address identified key risks, to gain an understanding of the overall process and to detail test the controls or risk mitigation strategy.

The Examiner-in-Charge needs to be assessing the appropriate approach to take in order to gain an understanding of key controls and testing through Phase 1 and 2. While it may not be necessary to complete a detail walkthrough, Examiners should work to identify and understand the key controls or risk mitigation strategies during the C-Level Interviews, review of external auditor workpapers, review of internal auditor workpapers, through client inquires, and review of any company documentation like walkthroughs, risk assessment & identified risk mitigation strategies, and other documents.

One method we find helpful during Phase 3 is to conduct key risk area meetings. Many may refer to these as walkthroughs however these meetings are hyper focused on key risks identified in Phase 1 and 2. Many times these meetings are customized based on size of the company, personnel in charge of key areas and other factors.

- For smaller examinations with limited personnel, we have scheduled a long conference call to have these key risk area meetings with the key members of management. In the agenda for the meeting, we provide the key risks identified in Phase 2 and the focus of the meeting/discussion. The focus of the discussion is to identify the key controls/risk mitigation strategies in place for the specific risks, to identify anyone we may need to set up additional meeting with to complete detail testing and/or to identify what materials we can request to test the key controls/risk mitigation strategies in place. We prefer these meeting to be conducted via video call with share screen feature like through WebEx or Microsoft Teams. We have found having this verbal discussion creates significant efficiencies and are more productive than the back and forth that occurs when you try to complete this through written requests and responses. Many times, this allows for direct feedback on controls that are not formalized or no documentation is available.

- For examination of larger companies, we generally delay these meetings longer until we have sufficient time to review any control documentation, internal audit and external audit work to identify key control and testing that may suffice to test these controls. Then, there will be meetings scheduled with separate individuals usually by each key risk area. These meetings usually include the Staff Examiners that will be testing these risks, the Examiner-in-Charge and exam specialists as necessary. The agenda and discussion items are the same however the only difference will also be including discussion on any risk mitigation strategy or key controls previously identified through examination work to ensure there is nothing else to consider.

- Lastly, be brave during these meetings. By this we mean, do not be afraid to ask pointed questions when there may be issues with key control or risk mitigation strategies identified. For example, a company may state that a monthly report is sent out for management to review and approve recent reinsurance transactions. In this case, we would ask pointed questions like what documentation is available, does the documentation show evidence of approval and try to review an example while on the call. In many cases, we find a risk mitigation strategy is weak when an insurer does not have any formal evidence of the control being completed. At times, this may be due to turnover in staffing, so email evidence was lost.

Examiners should be careful when deciding in Phase 1 and 3 on the level of reliance to place on external auditor control testing. It is likely external auditors will be focusing their test plans on substantive testing, analytics and/or covering bare minimum on financial key controls especially given increased remote work environment. A few reminders: 1) Financial auditors are not required to complete detail control testing or walkthroughs. 2) The external auditor is only required to identify key controls and complete limited testing to verify accuracy of controls identified by management like through testing one example. 3) External auditors only need to focus on key controls to address financial statement risks, which may also include certain controls in corporate governance and information technology.

Given many companies changed from office to remote office setting and/or hybrid model, Examiners should make sure to ask about changes in the control environment or evidence available as a result of these changes. Examples include rather than manual sign off now management may approve via email. This sometimes can cause issues if emails are not saved and/or if there is turnover in staffing. There could also be delays or issues as personnel may cut corners due to time delays or other issues.

One final consideration is that Examiners should be sure to always work to improve their documentation in Phase 3. Some areas to focus on is the specific risk mitigation strategy for each control, the testing completed, the sample size sufficiency, and why a risk mitigation strategy was assessed as strong, moderate or weak. This documentation becomes more important than ever to ensure sufficient and timely completion of an exam when the exam team is working in different locations. Not to mention speeds up the review process and lessens risk of accreditation or peer review comment.

Avoid the examination becoming a desk audit

There is a growing need with exams becoming even more remote in the new normal for Examiners to avoid their financial examination becoming a desk audit.

Many companies have limited resources especially in terms of personnel and time. As a result of limited resources, exam contacts may focus too much on providing written responses and turn the responses into checklist rather than responding completely. How to avoid this issue:

- First and foremost, we try to avoid sending requests Friday night and when possible sending it at the end of the day. It helps to set the tone that exam contacts need to prioritize their responses to not be the last thing on their list for the day when they are likely trying to respond as quickly as possible so they can be done for the day.
- Consider if it is better to make each request in writing or to discuss requests during an ad hoc meeting with a written request coming later.
- Consider arranging specialist meetings – we like to arrange these meetings especially when completing Phase 3 and 5 or when trying to gain a better understanding of a key topic.
- Reminder – No one is perfect and communication may not always be clear. Make sure to have status calls with the company and with the department to cut down on confusion with written requests.

- Everyone has limits to their time and resources so approach that with the company when making requests.
- Whenever meeting with the company and/or the department, always send a written agenda. Don't feel that you need to stick the agenda exactly and/or make it too detailed.

Cybersecurity and Risk Considerations

Cybersecurity is another majority consideration with the shift to remote examinations. Examinations deal with large amounts of confidential data that must be secured. The start of any good cybersecurity setup is their own home office. This is especially important if your home includes other people such as family members or roommates. The Examiner should try to have a home work space that is separate from other household members and secure their work space when not using it. If possible, try to have a dedicated area for working when at home. If not possible, try to move work related computers and equipment to a private area that can be secured when done for the day. As many department personnel and company personnel are moving to remote work in the new normal, it is important for them to consider their own home office set up.

While most Examiners don't consider their home network's setup, it is actually a very important part of cybersecurity. The most secured home network is a hard-wired network. It is also the most reliable setup as the connection will have a more reliable signal. Wireless network connections are the other option. Wireless networks are more convenient and easier to setup, but they are less secure than wired networks. Examiners should take the following measures to better secure their wireless networks: use WPA2 or better encryption, frequently change the administrator password on the router and disable guest access.

Examiners should use a Virtual Private Network (VPN) to create an encrypted tunnel between your computer and the server. The use of a VPN prevents someone from spying on the data packets on a network. This is especially important if the network you use for work is shared with others (including your household) or if you are working on a public network.

Examiners should also consider the environment that they choose to work in when they work remotely. If an Examiner is working as a "digital nomad" or if they are working from a remote location that is not located in their home such as a coffee shop, there are additional risks that must be considered. Examiners should not connect to public Internet networks even if they are using VPNs. Most phones include hotspot data plans which can be used for a more secure connection, or a hotspot "MiFi" from a cellular service like Verizon can be used. Coffee shops and other public locations also have additional privacy concerns as other people are able to see what is on the Examiner's screen including PPI and PHI along with confidential company information. Examiners should take care to use their own Internet connections when traveling and avoid working with confidential information in a public place. There are locations in most metro areas that rent out office space which can be considered. Also, a hotel room can work as an office, too.

If not already implemented, States should consider requiring contractors to either supply their own secure connections or have them use one setup by the state or NAIC. As a best practice, states should consider requiring secure connections as part of their contracts. Also, both contractor firms and states should consider covering cybersecurity in their policies including any third-party contractors.

Secure file transfers (FTP) should be used instead of email to transfer files. Email may not be encrypted or, depending on the state, be subject to Freedom of Information Act disclosure for state examiners. Using FTP will reduce the chance of confidential information being inadvertently disclosed. Most companies, states and contractors will have their own FTP setup.

Cybersecurity Concerns don't just end with the Exhibit C. Here are some other areas that the Examiners should consider when completing the examination:

- C Level Interviews: Consider adding questions to interviews with non-IT executives about cybersecurity. Note any concerns and level of cybersecurity threat knowledge from executives or if there is lack of concern regarding cybersecurity risk.

- Walkthroughs: Since most controls have some sort of IT related system, it might be a good idea to include questions during the walkthrough about how cybersecurity is included.

- Cyber Insurance Policy: This policy should be requested as part of the Phase 1 information requests. It is important to review policy for coverages and limits. Note if company does not have a policy and/or if any limitations are noted in conditions or definitions. For example, some policies might only cover losses for computers owned by the Company or only when on company property. This can cause a gap in coverage if employees are working remotely or are using computers not owned by the company.

- Remote Work Policy: Check for how the Company plans on monitoring cybersecurity for remote workers. Look for how the Company maintains services like VPNs and monitors network activity.

- Home Office Policy/Inspections – safe/secure: Workers' Compensation claims related to remote workers are on the rise. How does the Company inspect home offices for safety and security? Do they perform virtual tours?

- Updates to the insurance coverages to factor in employees working from home such as Cyber, Workers Compensation, etc. Check the policy to see if there are any location restrictions. Remote employees in states outside the state the home office is located may need amendments to the agreement to cover state specific requirements.

- Given many companies are moving to remote work as well, discuss on calls what is their company's IT security in place that they must follow, what is their document retention/destruction policy when working from home, what process or controls changed as a result of remote work now etc.

Closing Remarks

In closing, we have identified numerous best practices for working in the new normal. We encourage everyone to consider these when conducting your future examinations or when analysts are monitoring companies. Also, plan to be flexible and adaptable to what may work best for each insurance department and company.

Change is constant. We will always have some new software, technology, or other requirements to address in conducting our work. With this always evolving "new normal", we would encourage everyone to be open to change and to learning on each examination while remembering the lessons we learned from our past experience.

About the Authors

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A Guide to Leveraging Economic Capital to Conduct More Effective Exams

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What is Economic Capital and Why is it Relevant?

Economic capital is a means of quantifying a company's capital needs based on the amount of capital that is necessary to support its risk exposures and execute its business plan. Because economic capital captures more than just the liabilities on a company's balance sheet, it can be a more useful and comprehensive tool for regulators to evaluate a company's capital resiliency in the event of unexpected losses or future uncertainties.

To conduct key aspects of an examination for large insurers, including assessing corporate governance and the Enterprise Risk Management (ERM) function, performing testing around the ORSA, and performing testing around the Capital Management Critical Risk Category in Exhibit DD, examiners need to have a basic understanding of economic capital and what it measures. This is especially true since the economic capital framework varies from company to company, meaning the economic capital figures are not directly comparable like the financial statements. Rather, examiners must form a ground up understanding of the economic capital framework and modeling process to evaluate an insurer's capital adequacy. This article is intended to equip examiners with an understanding of the fundamentals and highlight what aspects of the insurer's processes should be considered or leveraged in key aspects of the exam.

To the extent that smaller insurers have the resources or expertise to employ the use of capital modeling, much of this discussion will be relevant. However, as with larger insurers, the level of reliance examiners can place on these processes for examination purposes will be dependent on the maturity of the insurer's ERM framework, including its ability to identify and incorporate all material, relevant risks into the capital modeling process. Other considerations include whether examiners can place reliance on the insurer's internal controls, including ITGC and model governance and validation processes. Examiners may also wish to leverage the discussion of external capital models, as these are more likely to be used by smaller insurers with limited modeling capabilities or resources.

What Risks Does Economic Capital Measure?

Economic capital measures financial and non-financial risks in terms of the capital they require, encompassing risks such as credit risk and market risk, as well as strategic risk, operational risk, reputational risk, insurance risk, and so forth. While there certainly can be overlap with the NAIC Exhibit L Branded Risk Classifications, note that companies are not required to use this framework or risk classification system, so it is important to gain an understanding of how a company defines risks within its organization.

While economic capital attempts to quantify the capital needed for a particular risk, note that some risks, such as reputational risk, are difficult to model and companies may rely on judgment instead to allocate a capital charge for the risk.

How is Economic Capital Measured?

Key components of measuring or calculating economic capital include the accounting basis, the risk horizon, the security standard, and the diversification benefit. Each of these is touched on below:

Accounting Basis. Economic capital is agnostic of accounting convention and is therefore not measured on a GAAP or SAP basis. Rather, it is measured on an economic basis of accounting intended to measure the realizable value of assets and the realizable cost of disposing of or fulfilling a company's liabilities. A frequent approach employed involves adjusting GAAP financials to remove intangibles and other assets not available to satisfy obligations, then reporting the remaining amounts at mark-to-market to reflect an economic basis of accounting.

Risk Horizon. Risk horizon is the period of time over which capital needs are projected, also commonly referred to as the "time horizon" or "return period." Companies may employ a **one-year** approach, which projects the balance sheet one year into the future on a mark-to-market basis and assumes that liability positions can be exited at the end of the year. Alternatively, companies may employ a **runoff** approach, which models capital needs through extinguishment of the liabilities and is essentially a cash flow testing approach. Generally, shorter time horizons are more credible as there is more uncertainty around assumptions further into the future, such as what interest rates will be or how equity markets will perform. For this reason, a one-year horizon is becoming the more favored approach and is required by Solvency II.

Security Standard. The security standard is a metric used to measure the risk of insolvency or default at a given probability or confidence level. A few of the most common metrics used to measure economic capital include the following:

- Value-at-Risk (VaR) – This is the most widely used method and measures the amount of capital needed to reduce the probability of insolvency or default to a given confidence level, such as 0.5%.

- Tail Value-at-Risk (TVaR) – TVaR quantifies the expected value of losses (or the severity of the losses) for an event that occurs outside of a given probability level. This is generally more conservative than VaR and is also known as the Conditional Tail Expectation or CTE.

- Expected Shortfall (ES) – ES is also known as the Conditional Tail Value-at-Risk or CVaR, and is more sensitive to the shape of the tail of a loss distribution.

Diversification Benefit. Economic capital is more than just the sum of individual risks within an organization—it also measures the interactions between risks. It is unlikely that every potential adverse scenario will occur in a given year, that all lines of business will experience adverse loss development, or that every investment will result in a default or impairment. Certain risks may be more likely to correlate, but on the whole, there should be some diversification benefit across a company's risk portfolio. Diversity across the lines of business, credit exposures, and other risks in an insurer's portfolio serves to reduce the total amount of capital a company needs in any given year to withstand unexpected losses.

Because simple aggregation of the capital requirements for individual risks assumes that a company will need to hold capital against all the risks occurring in a single year, companies employ various methods to recognize the impact that risk interactions have on economic capital. To account for these interactions and estimate diversification benefits, common methodologies employed by insurers include the use of copulas and correlation matrices. Copulas can be used to capture some of the more complex relationships between extreme stress scenarios in the tail distributions for two risks, particularly where there are non-normal tail distributions; but their use may not always be the most appropriate or practical. Far more commonly, companies employ the use of correlation matrices, or even a combination of both approaches.

Under the most common approach, correlation matrices are used to apply correlation coefficients across individual risks, lines of business, and business units or segments to arrive at the total economic capital for the enterprise, accounting for the diversification benefits that occur at each of these levels. Within this framework, correlation coefficients are assigned ranging from 0 to ±1, with 0 representing no correlation (or complete independence), 1 representing 100% (or perfect) correlation, and -1 representing -100% (or perfect inverse) correlation. For any correlations less than 1, the organization will incur some diversification benefit.

When two risks are independent or when they bear an imperfect correlation (of less than 1), there is a reduced likelihood that the two risks will coincide, meaning that the company can hold less capital against the likelihood of them both occurring in the same year. Even more evident is the diversification benefit arising from perfectly inverse correlations, where if one risk occurs, the other does not. For these scenarios, it does not make sense for a company to charge capital for both risks occurring, and so the capital requirements to support these risks will be offset. The amount of offset recognized contributes to the overall diversification benefit. (To account for concerns over extreme stress scenarios, such as an extreme pandemic that could result in the occurrence of multiple risks which do not normally bear significant correlation outside of these scenarios, companies may utilize stress testing and/or use of copulas in addition to the correlation matrix.)

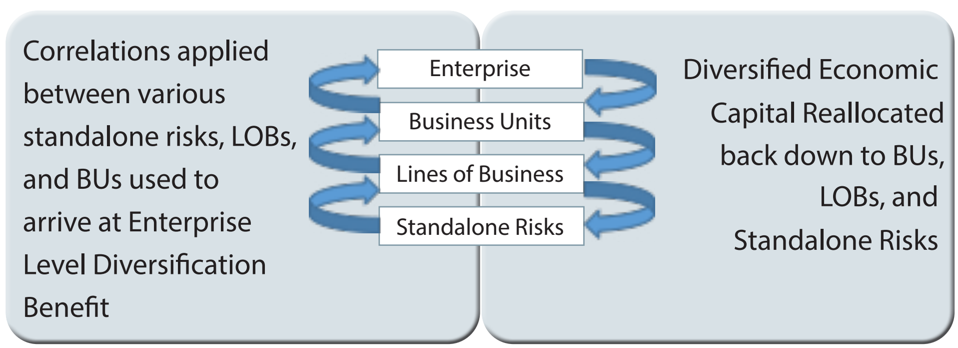
For two risks which are perfectly correlated, companies should recognize the full amount of economic capital necessary to support each of the risks occurring, given that these risks will always occur in conjunction with one another.

Generally, correlations between risks will be captured through various risks' response to a common risk driver. One such example may be a decrease in oil prices increasing the risk of default or impairment on investments with exposure to the oil and gas sector, as well as increasing the loss experience on private passenger auto. (This is due to the decrease in oil prices driving an increase in the number of miles driven.) Another such example is the relationship between investment portfolio losses and losses on errors and omissions coverage, each of which are driven by financial market performance.

One important caveat with respect to diversification benefits is that overestimating the total benefit to be taken will result in an understatement of the company's economic capital, which may lead the company to accept more risk than it intends. A company may have robust processes in place around capturing and calculating all of its risk exposures, but those efforts can be undermined if some measure of conservatism is not employed in determining the correlation matrix values. For this reason, companies may rely on the use of industry standard indices or correlations, such as S&P's; but if they instead rely on internally developed correlations, examiners should ensure that sensitivity testing is performed around the correlation matrix values.

Using Economic Capital

Once the diversification benefit is calculated and an insurer arrives at its enterprise level diversified economic capital output, it may then allocate diversified economic capital back down to the business units, lines of business, products, and individual risks. These amounts may then be used by management to make capital management decisions, such as how much capital to allocate to each of the business units. Companies may also express risk limits for each of the business units, products, etc. in terms of the allocated diversified economic capital, against which actual amounts would be monitored.



Allocating diversified economic capital back down to each level of aggregation also allows companies to evaluate performance in terms of how much revenue a product, a line, or a business unit generates in relation to the risk capital that it requires. This is referred to as capital efficiency or Return on Risk Adjusted Capital (or RORAC), and it plays an important role in management's decisions around business mix. (That is, companies seek to maximize returns without having to assume too much risk or having to hold onto capital that could be more efficiently invested elsewhere in order to generate additional revenues.) Metrics such as RORAC are also used in executive compensation to incent prudent decision making, as it ensures that management is not rewarded for taking extreme risks, even if those risks generate substantial profits.

Other important capital metrics. Other capital metrics used by insurers include **Available Capital**, which is the capital available to satisfy the company's obligations. Companies may define and calculate this figure differently, but it should be adjusted to remove intangibles. Companies may also include capital from long-term debt issuances in this figure. Available capital is calculated to determine the amount of actual capital that is available to support the risk exposures; and companies compare this figure to economic capital to ensure they are adequately capitalized. In performing this comparison, companies calculate **Deployable Capital**, which is the excess of a company's available capital over its economic capital. Deployable capital metrics are important for a company to evaluate how much discretionary capital it has available to pay dividends, engage in share buybacks, and allocate towards new strategic initiatives not already incorporated into its business plan and capital modeling. Deployable capital may also be used by insurers in consideration of potential M&A activity.

EXAM CONSIDERATIONS

Economic capital has implications for several key aspects of an examination, including corporate governance and ERM assessments, the ORSA assessment and testing, and testing for the Capital Management Critical Risk Category as follows:

Exhibit M – Corporate Governance

Risk Culture and Governance. Economic capital is a useful tool for management to incorporate a risk management lens or perspective into the strategic planning process. Business decisions should be scrutinized in light of their impact on economic capital in order to ensure that the organization has enough capital to support its business plan; and this process should be iterated throughout the strategic planning process. To complete the feedback loop, strategic plan assumptions should also feed the assumptions in the economic capital model.

Examiners should obtain a sense during interviews of how well management and directors understand economic capital outputs and how to use them to support their decision making, as well as what is driving changes in economic capital from period to period. During review of board and committee package materials, consider any training or educational materials provided to management and the board which facilitate this understanding. Examiners should also leverage review of these materials to ensure there is transparency with the board or its risk committee on the impact that potential strategic initiatives would have on risk capital.

Additional risk culture and governance considerations include the role that RORAC or other economic capital metrics play in determining executive compensation, as well as what role, if any, that stress testing results play in planning or business decisions.

Risk Identification and Prioritization. Within risk identification and prioritization, it's important to ensure that the insurer has a robust process for identifying all material, relevant risks, including emerging risks. Omission of material risks can result in understating economic capital (and thereby the company's risk exposures and capital needs), which can lead management to assume more risk than it intends. Examiners should also consider how frequently risk prioritizations are reassessed and how often emerging risks are incorporated into the modeling results, where possible, so that management has adequate time to respond to changes in the external environment. For risks which are difficult to quantify, either due to the nature of the risk or lack of available credible information, it may be worth having a conversation with the company to understand how the risks are captured and whether the company judgmentally allocates a capital charge for the non-modeled risks.

In prioritizing risks, the NAIC Financial Condition Examiners Handbook[1] (the "Handbook") recommends consideration of whether risk assessments take into account probability, potential impact, and time duration, which economic capital metrics inherently account for.

Risk Appetite, Tolerances and Limits. In order to evaluate the appropriateness of a company's risk appetite and risk tolerance, examiners should evaluate whether they are consistent with the company's business plan and economic capital targets, as management should not accept more risk than it has the capital to support. While there are a variety of ways that a company may express its risk tolerance and limits, economic or risk capital is one such means a company may choose to do so; and this can ensure that the company is making decisions around the acceptance of risk based on the amount of capital those risks will likely require. Because economic capital captures the impact of the business plan on risk capital, it can also facilitate alignment between a company's risk tolerance and its business plan when used in this manner.

Other pertinent considerations include whether stress testing results inform management's decisions around risk tolerance, and Handbook[2] guidance also suggests evaluating whether the insurer considers legal entity regulations and capital requirements in setting its overall risk appetite.

Risk Management and Controls. In evaluating risk management and controls, obtain an understanding of the actions taken by management to respond to changes in the risk profile that may exceed the economic capital targets or limits. Consider whether management and the board review what is driving changes to economic capital from period to period. For example, are these changes really the result of a change in a specific component of the company's risk profile, or are these the result of changes in the assumptions or methodologies? Controls over the economic capital model, along with any other models which feed its inputs, are imperative in ensuring the integrity of the economic capital outputs. An important aspect of a strong control environment is whether the economic capital model and any model supplying its inputs undergo audits or reviews by internal audit, an independent model validation unit, or external parties.

Risk Reporting and Communication. With respect to risk reporting and communication, if a company expresses its risk limits in terms of economic capital, important considerations include how frequently economic capital is recalculated and reported to management and the board for monitoring. The recalculation and reporting frequency should allow management to respond to breaches of risk limits in a timely fashion. However, there will be trade-off limitations between the timeliness or frequency of reporting versus the accuracy of the outputs. Handbook[3] guidance recommends selecting a sample of ERM information reported to the board for comparison to the ORSA Summary Report in order to validate accuracy and consistency in reporting.

Another key aspect for consideration is whether the economic capital outputs are prepared or reviewed in time to support the strategic planning cycle, and whether they are actually incorporated into the planning and decision-making process by senior management. Strong reporting and communication practices also include disclosing to the board the impact that any proposed initiatives would have on economic capital prior to their signoff or ratification of the initiatives. Finally, management, the board, and anyone who uses the outputs to make business decisions should be formally apprised of the key assumptions and limitations.

ORSA Considerations

Section I – Insurer's ERM Framework

Because Section I of the ORSA is essentially a recapitulation of the Exhibit M ERM considerations, those considerations will not be revisited in depth in this discussion. For ORSA purposes, to support a strong maturity rating which allows examiners to place a high degree of reliance on the insurer's ERM framework and controls, economic capital outputs and other risk management metrics should be used to support strategic planning, capital management and allocation, and other business processes and daily decision making. Economic capital should also be monitored on a periodic basis that allows management to identify and respond to changes in the insurer's risk profile in a timely fashion, with emerging risks incorporated into this calculation where feasible.

Section II – Insurer Assessment of Risk Exposure

Stress Testing. While the Handbook prescribes no particular approach to performing stress testing, examiners should ensure that stress testing is commensurate with the insurer's risk exposures and complexity, and note whether the approach relies on stochastic, deterministic, or reverse stress testing methodologies. Stochastic approaches, which are dependent on the distribution of outcomes from numerous simulations, should select a more remote return period than that employed in the company's economic capital modeling in order to obtain the benefit of performing stress testing. For example, a company may choose to apply a 1-in-500 year return period if its economic capital modeling applies a 1-in-200 year return period across various aspects of its business, though examiners should note that the company may not consistently apply the same return period across all lines of business or across the entirety of its risk portfolio.

For deterministic stress testing, which applies the effects of certain parameters determined by the company (say, for example, a 30% equity shock or catastrophic losses commensurate with that of Hurricane Sandy), it is important to consider the rigor applied and determine whether the parameters are comparable to that of historical events. For example, examiners may evaluate whether credit stresses, including assumptions regarding default rates on high yield or investment grade bonds, are commensurate with that in past recessions or economic downturns. Though no specific deterministic scenarios are required by the Handbook or ORSA guidance, a couple which may provide examiners with a strong degree of comfort include a scenario with multiple catastrophic events and a 1970s stagflation scenario, both of which result, oftentimes, in some of the largest impacts on capital of any of the stress scenarios performed by insurers. Companies may also employ the use of the Federal Reserve's CCAR scenario.

A reverse stress testing approach entails evaluating the severity of an event that would be necessary to reach some threshold, such as eroding earnings and resulting in an impact to capital, or the magnitude of events which would be required in order to result in a ratings downgrade or action level RBC. It is at the company's discretion to determine which threshold it would like to assess its capital resiliency against. For reverse stress testing, it may be helpful to ask the company for benchmarks for comparison, such as catastrophic wildfire or hurricane losses for a particular year or event with significant losses; and examiners can then evaluate the amount of these losses against the magnitude of the reverse stress scenario. Examiners should note that a company may choose to employ any combination of these stress tests in Section II of the ORSA.

Section III – Group Assessment of Risk Capital

Within Section III of the ORSA, the focus for examiners should be on understanding the *process* the insurer used to accumulate and present the information provided. The examiner's approach to doing so will depend on whether the company utilizes an externally developed capital model, such as S&P's or A.M. Best's BCAR model, or whether the company utilizes an internally developed capital model.

External models. Per the Handbook[4], the examiner should consider "what validation efforts have been conducted to allow reliance to be placed on external models." Furthermore, lead state examiners should "consider whether the insurer applies a reasonable range of stress scenarios to the outputs of these models under a wide range of different scenarios."

External models do not require the same level of independent testing by the examination team as internal models; and testing performed by the examination team should generally focus more on procedures such as validating the model inputs (e.g. through accuracy and completeness testing) and obtaining documentation supporting any judgmental overrides of the model outputs. A key consideration when evaluating external models is that they will not capture an insurer's idiosyncratic risk since they are calibrated using industry data.

Internal models. For internally developed capital models, additional emphasis should be placed on evaluating the strength of a company's model validation processes and model governance controls. Due to the "challenges inherent in developing, implementing, and maintaining an effective internal capital model," the Handbook[5] states that "[d]epending upon the strength of the insurer's internal model validation processes, Lead State examiners may need to perform some level of independent testing to review and evaluate the controls over internal model(s) utilized by the insurer for its group economic capital calculation."

Examiners may find it appropriate to request additional detail supporting the group capital calculations and involve an actuary in the review. Examiners may also find it appropriate to involve an IT specialist to evaluate access controls, change controls, backups, archiving, and other aspects of the ITGC environment for platforms used to run the models, including any platforms or applications which feed the model inputs. Where independent testing is warranted, the Handbook[6] indicates that testing may consist of procedures to evaluate the appropriateness of assumptions and methodologies used in both: (a) stochastic/deterministic modeling scenarios for individual risks and (b) estimating the amount of diversification benefit realized. In doing so, examiners may need to select a sample of individual risks for review and consideration, again involving the actuaries to assist in the evaluation.

Testing for economic capital models will generally follow that performed around model risk. These tests typically fall under model governance and model validation processes:

Model Governance	Model Validation
- Model team resources - Model use and limitations - Ownership of data and external P&A - Governance over key P&A - Governance over model overrides - Model controls - Model testing - Understanding and challenge of model results - Model documentation	- Appropriateness of model methodology - Re-performance of model calculations - Sensitivity analysis of the P&A - Back-testing and evaluating reasonableness of outcomes - Evaluation of model overrides - Data Validation

Although model governance and model validation processes do not perfectly correspond to Phase 3 and Phase 5 procedures, Model Governance can generally be conceptualized as involving Phase 3 controls over the models and Model Validation as involving a Phase 5 substantive review of the models. Financial examiners should be able to perform testing around the model controls and can involve actuaries in performing the substantive review of the models, such as evaluating the appropriateness of the methodology or reperformance of the calculations. However, a company with a strong risk management function should have controls in place to ensure there is independent validation of its internal capital model(s), whether by internal audit, a dedicated model validation unit, a separate modeling or actuarial unit that is independent from the design and implementation of the models under review, or from a third party engaged to review the models. Where actuarial resources are limited, examiners can perform control tests to ensure that these independent validations occur on a periodic basis and according to the control guidelines. Examiners can also perform accuracy and completeness data testing around the model inputs during Phase 5 procedures.

- **Model Governance.** One of the more critical model governance controls that should be in place is maintenance of model documentation to give context to external parties auditing or validating the model, as well as to anyone who needs to operate the model in the event of key staff turnover. Aspects of each model which should be documented include the purpose, key assumptions, limitations, model inputs, how outputs are used, the date of the most recent changes to the model (along with version control references), the date of the most recent internal or external validation, and reasons for any model overrides. Each model should also have an owner responsible for maintaining the documentation and validating the model inputs.

- **Model Validation.** With respect to Model Validation, back-testing and independent validation are a couple of the more critical validation processes that can provide the most comfort over the reliability of economic capital outputs. Back-testing helps with assessing how reliably the outputs have historically performed on an ex post facto or look-back basis. Independent validation is perhaps the strongest control a company can have in place around a model and involves having a party which is independent from the design or implementation of a model to perform an independent review of the assumptions and methodologies. Parties performing this review should have the requisite experience and expertise.

  Additional model validation procedures that should be performed include a sensitivity analysis of the correlation matrix values used in calculating the diversification benefit, given that overestimation of the diversification benefit will lead to an underestimation of the company's economic capital outputs and capital needs. Companies may also impose parameters on the values in the matrices limiting the amount of diversification benefit that can be taken as a means of exercising some degree of conservatism, or they may also utilize industry correlation indices, such as those available from S&P.

Exhibit DD - Capital Management Considerations

The Capital Management Critical Risk Category encompasses an insurer's ability to assess, manage, and maintain sufficient capital to sustain its business plan and solvency position, which economic capital models inherently capture. Additional considerations include the ability to forecast capital needs or identify contingent sources of additional capital.

Testing performed around an insurer's capital models can be leveraged for ORSA testing, model risk, and Exhibit DD Capital Management risks in order to capitalize on examination efficiencies. This is especially relevant if the company is using economic capital outputs to make decisions around capital management or to support its business plan, which is a requisite for a mature ERM assessment. To coordinate the testing of Capital Management risks with ORSA testing, examiners should forego generic risk statements from the repository (such as "the insurer is not monitoring its capital and surplus needs") given that testing for these risks generally focuses more on vouching the existence of capital modeling processes rather than evaluating their effectiveness. Instead, risk statements should be geared towards whether the company is able to *effectively* anticipate its capital needs (thereby focusing on the *accuracy* of model outputs); whether the economic capital model's assumptions and methodologies are appropriate; or whether the diversification benefits are overstated. Whatever the risk statement, it should allow examiners to test the effectiveness of controls and model validation efforts in place over the company's capital modeling process.

Forecasting Capital Needs. In addition to the Model Governance and Validation testing that can be performed to evaluate an insurer's economic capital model (as discussed in ORSA Section III), additional considerations when evaluating a company's Capital Management practices may include the following:

- Whether economic capital projections include key assumptions from the strategic plan, such as growth of particular lines of business, adjustments in investment allocations, shifts in underwriting guidelines or changes in policy limits, and changes in the reinsurance program. Examiners can also review minutes and package materials from management committees, including senior risk committees on which the C-levels sit, to ensure that key business decisions and planning were evaluated in light of the risk capital they would require. Management should also consider any proposed expenditures, such as M&A activity, in light of the amount of deployable capital available.

- In evaluating its available or deployable capital, management should also consider the fungibility of capital between legal entities. For multi-national insurers subject to Solvency II, foreign capital requirements will impact capital fungibility; and both tax and currency exchange rates will also impact the company's ability to repatriate capital. For US-domiciled insurance subsidiaries, capital fungibility will be subject to minimum surplus and RBC requirements.

Identifying Contingent Sources of Capital. Economic capital models may factor in the capital necessary to maintain a minimum rating agency rating, or this may be evaluated through the use of an additional or separate rating agency model. This is often part of an insurer's consideration of contingent sources of capital, given that a ratings downgrade impacts the ability to make debt offerings or obtain a credit facility, as well as how much it will cost the company to borrow capital.

Further, companies often use deployable capital to make decisions around planned dividend and share buyback activity. Economic capital models often build in assumptions around these activities, as do external capital models such as the S&P model. Oftentimes, companies may plan to suspend or decrease dividends and share buybacks during capital shortages as an additional means of ensuring it has adequate capital.

Capital Modeling Limitations. A capital model is not considered useful for measuring liquidity risks, as holding capital against liquidity is largely viewed as ineffective and inefficient. Capital models also do not necessarily forecast cash flows, as it's more appropriate for cash flow forecasting to be performed using an earnings model or a cash flow model.

Conclusion

Economic capital is one of the most useful tools for evaluating an insurer's capital adequacy and, for large organizations, it plays a central role in many aspects of their operations, from risk management and corporate governance processes, to strategic planning and capital management. For this reason, examiners should have a basic understanding of economic capital to inform their approach to these aspects of the exam.

Further, leveraging testing of an insurer's capital models across the Handbook's recommended ORSA testing, Exhibit DD Capital Management testing, and model risk testing can help examiners achieve exam efficiencies while simultaneously addressing some of the more critical risks to an organization.

Footnotes:

1 NAIC Financial Condition Examiners Handbook, 2021 Edition, Exhibit M, page 498

2 Financial Condition Examiners Handbook, 2021 Edition, page 164

3 Financial Condition Examiners Handbook, 2021 Edition, page 165

4 Financial Condition Examiners Handbook, 2021 Edition, page 169

5 Financial Condition Examiners Handbook, 2021 Edition, page 169

6 Financial Condition Examiners Handbook, 2021 Edition, page 169

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Captives can be an Insurtech Accelerator

By Stephen R. DiCenso, FCAS, MAAA
Milliman

With the immense financial and operational challenges brought on by the spread of the COVID-19 pandemic, many insurers have had to dramatically cut back on insurtech funding. Insurtech solutions were starting to help insurers improve their commercial customers' buying and claims experience. We all await the day when the impact of the virus has been minimized and the insurtech movement swiftly picks up pace again. After all, there is no doubt that insurtech is here to stay.

Even before the coronavirus, however, obstacles existed that slowed the uptake of insurtech solutions that targeted the reduction of customers' losses. In fact, this problem can be addressed with traditional industry solutions – captive insurance companies – which can act as insurtech accelerators.

But why do delays in implementation occur? Insurers rightfully want to leverage insurtech solutions to quickly find the insureds with the lowest risks of loss and charge them premiums that generate the most profit. At the same time, customers want to adopt these technologies to reduce costs, and they rightfully expect corresponding premium reductions.

Competing Dynamics

But insurers naturally are reluctant to offer these premium credits in full, because of the uncertainty of the new technology and their desire to retain more premium. Of course, insurtech providers have confidence in the efficacy of their products. These competing dynamics are working to slow down the adoption of insurtech solutions that can ultimately make a customer's business more efficient and profitable.

For instance, the insurtech might think that a smart sensor technology such as a water shutoff system will reduce the cost of commercial property water damage claims by 50% or more. As the technology has never before been implemented, the insurer decides to offer a 10% premium credit to the insureds that want to invest in having it deployed at their locations.

If the technology is truly as effective as advertised by the insurtech firm, the insurer will ultimately gain the benefit of the additional 40 or more percentage points of reduced losses. That seems neither fair nor the best means to get the technology out to market faster. And while there may be some movement by the insurer to increase the premium credit next year to, say 15%, in light of these superior results, it will be a long time before the credit reaches 50%, if ever.

Financially Flexible

So how do we resolve the dilemma and accelerate this customer benefit while still providing the insurer with a reasonable profit and allowing the insurtech provider to sell more of its product? The answer is to create a captive to act as an insurtech accelerator. Captives are financially flexible, regulated insurance vehicles that also provide a robust governance structure. Here's how a captive can be leveraged for insurtech formation:

An initial expected quota share of premiums and losses and other costs (including the cost of technology) are ceded to the captive. The "insurable risk" (or captive premium) is the risk that losses do not meet the agreed-upon price reduction of the insurer (10% in the above example). If losses are reduced much more than 10%, the captive gets an increasing share of the upside benefit (i.e., a lower share of losses is ceded to the captive). If losses are reduced less than 10%, the captive absorbs an increasing share of the risk (i.e., a higher share of losses is ceded to the captive).

This downside risk would be set such that risk transfer requirements are met, but the captive will not take so much risk as to expose the insured to an uncomfortably high level of losses.

Again, the reason for forming the captive is to absorb the risk that losses do not meet the loss reduction level as priced by the insurer. The captive is now taking the place of the insurer, to stand behind the efficacy of the product.

The captive could take the form of a pure captive (owned by the insured) if it is willing enough to take on the execution risk of this product. Alternatively, if the insurtech startup is formed as a managing general agency (MGA), it could create a captive, likely with the support of the insured and other investors to take on this risk. If the insurtech is already structured as an insurer, then setting up a captive can be even easier. In these latter two scenarios, other insurers could provide capacity as quota share reinsurers.

Of course, absorbing this start-up risk is possible through other means – writing a retrospectively rated policy with an insured, or having a sliding scale commission arrangement with an MGA. But one common challenge for any of these structures is to ensure that losses are tracked in sufficient detail and predictable enough so that the impact of the technology on costs is easily determined.

Here, the captive solution can be superior for the following reasons:

- It provides an overarching governance framework (e.g., board of directors, bylaws, captive manager, and other independent service providers)
- It can have an independent actuarial estimate of the savings versus relying solely on the insurance company's actuary
- It will not be subject to clauses that dictate when and what portion of the commission can be paid
- It has some (limited) tax advantages.

- The insurer may be "losing" some of its premium via cession to the captive on an individual deal but, to the extent the technology is proven to be successful, these deals will become much more common under this framework and lead to much higher revenue opportunities than without it. The insurer can also recoup revenue via services fees, and can protect its own downside risk by using the captive, despite some additional captive operating costs.

The insurance ecosystem is stronger via collaboration. Leveraging captives to enhance the existing relationships between traditional insurers and the insurtech community, and accelerating the deployment of new tools, creates a "three-legged stool" ecosystem that enables advancement while providing risk protection.

As the globe faces new economic challenges, now is the time to gather together insurtech providers, insurers and corporate insureds to discuss how captives can be used to incentivize the quicker adoption of these cost-reducing technologies.

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About the Author

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PwC NAIC Newsletter

Summer, 2021

The National Association of Insurance Commissioners met this spring and summer including the first "in-person" National Meeting since December 2019. This newsletter contains information on activities that occurred in meetings since March 2021, with a focus on the Summer National Meetings and subsequent conference calls through September 20. For questions or comments on this Newsletter, please feel free to contact us at the address given on the last page.

In this issue

Executive summary

- During their Executive and Plenary meeting in August, the commissioners voted to adopt new guidance on accounting for agent commissions to prevent the deferral of expense. The commissioners also voted to reject a proposed model law to regulate pharmacy benefit managers.
- The Special Committee on Race and Insurance continued its work to develop tools to assess unfair discrimination in insurance transactions. Workstream 5, which is addressing health insurance issues, exposed for comment draft principles for data collection of personal information, including race, ethnicity, and gender identity.
- The Group Capital Calculation Working Group finalized the parameters of its trial implementation of the GCC template and instructions using 2020 data; the regulators hope to have feedback from the trial, with proposed refinements to the template for 2022 implementation, by the Fall National Meeting.
- The Statutory Accounting Principles Working Group agreed that the Proposed Bond Definition developed by a small industry and regulator subgroup should be the framework for a principles-based definition of Schedule D-1 bonds. NAIC staff will now work with the subgroup to develop an issue paper and a package of proposed changes to the investment schedules, with an "earliest possible effective date" of January 1, 2024.
- All three RBC Working Groups adopted significant changes to RBC for year-end 2021, which are summarized in PwC's RBC Special Edition Newsletter.
- The Risk-Focused Surveillance Working Group exposed for comment optional guidance to regulators on the review of affiliated service agreements that include market-based expense allocations.
- The VOS Task Force adopted a requirement for insurers to file private rating letter rationale reports for certain private letter rated securities beginning January 1, 2022 and finalized guidance on credit tenant loans. The SVO's Structured Securities Group agreed in principle to defer until year-end 2022 the use of 20 price points for financially modeled RMBS and CMBS to correspond to the 20 new NAIC designation categories for RBC.
- The Blanks Working Group discussed a controversial proposal to add a new supplemental schedule to the P/C Annual Statement to capture statistical data related to premiums and exposures for four lines of homeowners and auto insurance.
- Nine new states will be participating in the NAIC's Climate Risk Disclosure Survey for year-end 2021. The Solvency Workstream of the Climate Risk and Resilience Task Force anticipates issuing for comment in November proposed enhancements to existing regulatory tools to further address solvency risks related to climate change.
- The Life Actuarial Task Force exposed for comment the first full draft of the VM-22, PBR for Fixed Annuities; the target effective date is currently January 1, 2024. In response to concerns raised by industry, the task force conceded that the new economic scenario generator currently in development will not be ready for implementation as of January 1, 2022, as initially hoped.
- The Mortgage Guaranty Issues Working Group adopted a new supplemental schedule, the Mortgage Guaranty Insurance Exhibit, effective for year-end 2021.

Executive Committee and Plenary

In addition to Executive Committee and Plenary adoptions discussed in various topics below, the commissioners adopted the following at the Summer National Meeting:

- Amendments to the Annuity Disclosure Model Regulation (#245) to allow for the illustration of participating income annuities, and

- Revisions to the Insurance Holding Company System Act (#440) and Regulation (#450) to provide guidance on the continuation of essential services through affiliated intercompany agreements to an insurer which has been placed in receivership.

During a heated debate at the Summer National Meeting, the Executive Committee declined to adopt the proposed Model Law Addressing Licensure or Registration of Pharmacy Benefit Managers (PBMs). The model law was meant to provide state insurance departments the authority to regulate PBMs rather than to regulate indirectly through the insurer. The motion to adopt failed due to the inability of states to reach a consensus viewpoint on how to properly regulate PBMs. Comments from commissioners included that their state has already adopted "more robust" requirements for PBMs, that states have no authority to regulate PBMs, and the view that the model does not address the issues that many states are interested in regulating. The chair of the Health Insurance and Managed Care Committee noted that work will begin on a PBM White Paper, which will 1) analyze and assess the role PBMs and other supply chain entities play in the provision of prescription drug benefits and 2) identify, examine and describe current and emerging state regulatory approaches to PBM business practices, such as price transparency and reporting requirements, and rebating and spread pricing. A draft of the white paper is not yet available.

Special Committee on Race and Insurance

During the Summer National Meeting, the Special Committee on Race and Insurance, which has been organized into five workstreams, adopted its 2021/2022 proposed charges and heard updates on the progress of each workstream. The workstreams are moving forward with the next phase of their work and will be meeting this fall to develop their work plans and provide recommendations.

Workstreams 1 and 2, the 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 survey 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 include developing analytical tools for state insurance regulators to use in defining, identifying and assessing unfair discrimination, including rating and underwriting variables, such as socioeconomic variables and criminal history.

Charges of Workstream 4, diversity and inclusion related to the life industry, 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, "considering the relationship between mortality risk and disparate impact."

Workstream 5, D&I initiatives related to the health industry, charges include continued analysis of measures to advance equity by lowering the cost of healthcare, promoting access to care through advocacy of telehealth and coverage, network adequacy and provider diversity, and outreach and education to consumers. Workstream 5 also exposed a draft principles for data collection best practices document, "to establish consistent high-level guiding principles for the collection and treatment of data on race, ethnicity, and other demographic characteristics in the business of health insurance." The draft principles include recommended standards for data collection for race and ethnicity information, preferred language, and sex, sexual orientation, and gender identity.

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.

Group capital calculation

State adoptions of the GCC – Three states, Missouri, Montana and Rhode Island, have already adopted the GCC requirements in their statutes (along with the liquidity stress test framework requirements).

GCC 2021 trial implementation — This summer the GCC Working Group finalized the process for a trial implementation using 2020 data and 25 volunteer companies and their related lead states to identify any issues with the GCC template and instructions. The working group hopes to complete the trial and related analysis by October 31, with discussion at 2021 Fall National Meeting and adjustments to the template for 2022 implementation. One of the last items finalized was a new stress test (for the trial only) to inform regulators and users how the limits on recognition of capital instruments as capital (such as debt) behave under stress. After discussion at several meetings, the working group and industry agreed to add a standardized stress scenario to the template, which is a 30% reduction in available capital and 30% reductions in certain entity-type's calculated capital, e.g. Financial Entities such as asset managers and non-U.S. (non-risk based) entities. Volunteers then have the option to stress additional entity-types' capital calculation by 30%. Also optional is a "stress narrative" in which group-specific stress scenarios using a specific percentage reduction in available capital, which may or may not align with the standardized stress of 30%. The volunteer company would then provide a brief narrative if a different stress percentage is more appropriate. The primary purpose of the standardized stress scenario in the trial implementation is to evaluate its impact on the amount of senior and hybrid debt that can be included as additional capital. However, the working group noted that there "may be some role in the future in the analysis guidance [discussed below] for reviewing how the GCC group assesses stress scenarios."

Financial Analysis Handbook exposure – The GCC Working Group exposed for comment in September proposed changes to the Financial Analysis Handbook, which include a "primer" on the GCC formula, discussion of the role of the GCC in financial analysis, use of the GCC in lead state's responsibilities, considerations of the ability of the group to raise capital, and a detailed five-step process for reviewing the filed GCC. Comments are due to the NAIC by October 29. The regulators plan to adopt the guidance for the 2022 Handbook.

State adoptions of the GCC – Three states, Missouri, Montana and Rhode Island have already adopted these requirements in their statutes (along with the liquidity stress test framework requirements).

Process for Evaluating Jurisdictions that Recognize the GCC – As specified in the adopted GCC requirements, an insurance group headquartered outside the U.S. is exempt from the GCC if its group-wide supervisor "recognizes and accepts" the GCC for U.S. groups doing business in that jurisdiction. In September, the Mutual Recognition of Jurisdictions Working Group exposed for comment until October 13 a revised draft Process for Evaluating Jurisdictions that Recognize and Accept the Group Capital Calculation.

Innovation and technology initiatives

The Innovation and Technology Task Force discussed an emerging issue in insurance around the ownership and access to consumer data. Numerous participants agreed that the issue is being discussed in many arenas, including consumer rights actions, regulatory discussions, and cybersecurity planning. As part of the discussion, participants from industry, consumer protection, and regulators brought various perspectives, noting it is a multifaceted issue that will require complex solutions, but is ultimately "solvable." The questions raised include who owns consumer data, who should have access to the data and via what technologies, and how the data is secured to prevent malicious use. Potential solutions likely include a combination of legislative or regulatory changes, use of cybersecurity technologies, and industry transparency around use of consumer data. The task force ultimately referred the matter to the Market Regulation and Consumer Affairs Committee but expects to continue work in this area in the future.

The task force also received an update on the adoption of Model #668 around insurance data security, noting the model has now been adopted by 18 states and is under consideration by two additional states currently. The task force noted the importance of getting this model widely adopted by states, to enhance a consistent data security framework to protect consumer privacy as well as industry data.

Big Data and AI Working Group – Prior to the Summer National Meeting, the working group solicited feedback on a draft survey sent to private passenger automobile insurers to better understand their use of artificial intelligence (AI) and machine learning (ML). Feedback from industry and interested parties focused on the need for more specific questions, as well as more distinct definitions of what separates AI from ML, and related techniques. The working group plans to use the feedback to better define questions to allow a more consistent response from industry members in the final survey.

Accelerated underwriting in life insurance – The Accelerated Underwriting Working Group was created in 2019 with the charge of considering the use of external data and data analytics in accelerated life underwriting. During the summer, the working group discussed the latest draft of the Accelerated Underwriting Educational report, which will focus on "what accelerated underwriting is, what accelerated underwriting does, and what the regulatory structure is or should be in the context of current laws," including how AI and ML are used in accelerated underwriting.

Statutory Accounting Principles Working Group

Significant actions taken by the SAP Working Group since the Spring National Meeting are summarized below. (Appendix A to this Newsletter summarizes all actions taken by the working group and the status of all open projects.)

Newly adopted guidance

Levelized commissions (#2019-24) - Non-substantive revisions to SSAP 71, Policy Acquisition Costs and Commissions, had been developed to address a contentious issue and prevent insurers from deferring the recognition of initial sales commission expense by entering into "funding agreements" or levelized commission arrangements. The adopted revisions to SSAP 71 require the reporting entity to recognize in full the initial sales commissions upfront at the time that the policy is sold and record a liability for the amount of the unpaid principal and interest payable to the third party funding agent. The revisions are effective December 31, 2021 for existing and new contracts and should be accounted for as a change in accounting principle.

Adoption of this guidance in March by the SAP Working Group was confirmed by both the APP Task Force and the Financial Condition Committee at their meetings this spring. Final adoption of the SSAP 71 revisions by Executive Committee occurred at the Summer National Meeting, during which the chair of the APP Task Force stated that the "the issue before us is one of the foundations of statutory accounting; i.e, that commissions are expensed from day one." A motion to delay implementation until year-end 2022 failed.

In connection with these discussions, the SAP Working Group recommended a new General Interrogatory to disclose whether an insurer utilizes third parties to pay agent commissions in which the amounts advanced by the third parties are not settled in full within 90 days. If so, the insurer must identify the third party that pays the agents and whether they are a related party. This proposal was adopted by the Blanks Working Group (2021-04BWG) effective for year-end 2021 annual statements.

SSAP 2R/INT 21-01, Statutory Accounting Treatment for Cryptocurrencies (#2021-05) – The working group adopted a proposed Interpretation that directly held cryptocurrencies do not meet the definition of cash and should be classified as nonadmitted assets.

SSAP 86/INT 2020-01, ASU 2021-01, Reference Rate Reform (#2021-01) – The working group adopted guidance based on ASU 2021-01, which relates to 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 through December 31, 2022 to change the reference rate used for margining, discounting, or contract price alignment that is a result of reference rate reform are eligible for this voluntary guidance that does not require hedge redesignation.

Significant exposures/discussions

SSAP 43R revisions (#2019-21) – This spring and summer, the SAP Working Group made significant progress on its project to revise SSAP 43R to address regulatory concerns, especially with securitizations done with equity-like investments that result in a bond classification after being rated as debt by a credit rating provider. During its May 2021 public hearing, the wording group exposed for comment its "proposed principles-based definition of a bond eligible for reporting on Schedule D, Part 1," (which was drafted by a small group of regulators, industry and NAIC staff) and which includes the following guidance:

> A bond shall be defined as any security representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset backed security**.**

The primary distinction between the two instruments is that repayment of issuer credit obligations is supported primarily by the general creditworthiness of an operating entity or entities, and asset backed securities are repaid primarily from cash flows associated with the underlying collateral (rather than cash flows from an operating entity). Examples of issuer credit obligations are provided, which are consistent with current guidance, i.e., bonds listed in paragraph 3 of SSAP 26R. The definition of asset back securities requires that cash-generating non-financial assets will generate a "meaningful" level of cash flows toward repayment of the bond and that the holder of the ABS is in a different position than if the holder owned the assets of the ABS issuer directly (resulting from "sufficient" credit enhancement of the ASB instrument).

The exposed document provides additional definitional guidance, detailed examples of instruments that do not meet the definition of a bond, and discussion of what constitutes a "meaningful level of cash flows" and "sufficient" level of credit enhancement, including a practical expedient for "meaningful."

During its August 26 meeting, the working group heard comments from industry, based on the three comment letters received. The "interested parties" comment letter states that they are "overall supportive of the proposed principles-based Proposed Bond Definition. We believe it is flexible enough to accommodate the continued evolution of the bond market, while having safeguards that help prevent potential regulatory abuses. It does come with a cost to industry though, which is primarily driven by the requirement to analyze and document that certain bonds meet specific thresholds ("meaningful" and "sufficient")." Interested parties agree that the examples of instruments that do not meet the bond definition (Appendix 1) are integral to the guidance and they have detailed recommendations on enhancing those examples. Another comment letter pointed out issues that will arise when instruments are moved from Schedule D, Part 1 to another schedule such as Schedule BA, with may result in an "other invested asset classification," which generally have lower investment limitations than bonds, as codified in state investment law.

After listening to the comments from industry, the SAP Working Group agreed the Proposed Bond Definition should be the framework as the project moves forward, with the caveat that "these concepts should not be considered final as further discussion and deliberation will occur throughout the process." The next steps enumerated by the working group are as follows:

- NAIC staff will begin development of an issue paper and SSAP to incorporate the bond concepts, including consideration of the comment letters received.

- Development of SAP guidance that specifically details accounting and reporting for instruments that are reclassified out of Schedule D-Part 1 reporting; for example, equity tranches of securitizations.

- Development of reporting revisions to provide for additional granularity in Schedule D-1 reporting, which is expected to include significant changes to the existing reporting categories.

The working group stated that the official "earliest possible effective date" of the package of accounting and report changes is January 1, 2024; the current intent is not to allow grandfathering, but some "transition accommodations" may be necessary.

SSAP 43R, Residual Tranches (#2021-15) – On September 10, the SAP Working Group exposed for comment proposed changes to SSAP 43R to clarify the treatment of residual tranches, which are characterized as "non-rated, first loss layers without contractual principal or interest." The guidance recommends classifying the instruments on Schedule BA and valued at the lower of cost or fair value and proposed effective for year-end 2021. The working group will also propose a Blanks Working agenda item to create a new reporting line specific for these items on Schedule BA. They will also recommend to the Valuation of Securities Task Force that they adopt guidance for the SVO Manual to specify that the NAIC 5GI process shall not be used to self-assign an NAIC designation to non-rated residual investments.re

Credit Tenant Loans (#2021-11) – See the summary of the VOS Task Force on page 8 for discussion of new guidance related to CTLs.

Policy Statement Terminology Change (#2021-14) – The regulators exposed for comment a proposal to revise the terminology when considering changes to statutory accounting from "substantive" and "non-substantive," to "new SAP concepts" and "SAP clarifications." This change in terminology was suggested by the Financial Condition Committee as a result of their discussions of the levelized commission issue (discussed above), to avoid possible future misunderstandings (e.g. that use of the term "non-substantive" was not meant to imply that a proposed change would not be material to some companies). The change will be implemented going forward and prior determinations of substantive vs non-substantive will not be revised.

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.

During its May meeting, the working group discussed comments from interested parties that the state ACA plans differ from both the former Federal ACA Reinsurance Program and from each other in various ways, which would make the proposed guidance difficult to implement. As a result, the working group plans to develop additional principle-based revisions to address the diversity in state programs with the following preliminary recommendations: 1) program reimbursements for claims costs should reduce claims incurred; 2) payments should be reflected as an assessment if a plan is only eligible to be a payer; 3) liabilities should be recognized when they meet the definition of a liability pursuant to SSAP 5R; and 4) the state ACA reinsurance programs admissibility guidance should be similar to the SSAP 107 federal receivables guidance. An issue paper has not yet been exposed with these proposed recommendations.

Risk-based capital

Earlier this summer, the NAIC adopted significant changes to all three RBC formulas effective for year-end 2021. PwC published an RBC Special Edition Newsletter summarizing those changes, which can be viewed here.

Market-based affiliated service agreements

As a result of an increase in the number of affiliated service agreements being filed for regulatory review with "complex, market-based expense allocations," the Risk-Focused Surveillance Working Group exposed for comment in August proposed revisions to the Financial Analysis Handbook and Financial Examiners Handbook. The revisions would provide guidance to regulators in their review of such market-based expense allocations as to whether they meet the "fair and reasonable" standard of holding company requirements. One proposed change to the Financial Analysis Handbook is to "consider whether additional examination procedures should be recommended to verify/validate information reported on affiliated services or to further evaluate the fairness and reasonableness of expense allocations."

Informal comments from industry indicated concerns that the proposed guidance could result in previously approved service agreements being disapproved. To address that concern, a September 7 email from NAIC staff (extending the comment deadline to October 29), included the following additional rationale for the exposure.

> As the evaluation of market-based expense allocations can be more challenging and difficult to determine whether they meet the "fair and reasonable" standard outlined in statute, additional guidance and considerations have been developed for both handbooks to assist regulators in reviewing and communicating regarding solvency risks in this area. However, it should be noted that the guidance is only intended for optional use in regulatory review (when relevant) and is not intended to impact the existing statutory authority over, or accounting treatment for, such service agreements.

Valuation of Securities Task Force

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

P&P Manual amendment adoptions
Private Rating Letter Rationale Reports – The task force adopted 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 there are no provisions to permit the SVO to reject any rating.

While this amendment is effective January 1, 2022, rules have been added to allows a two-year transition period for acquisitions after January 1, 2022 and also exempts securities issued prior to 2018 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 (and the NAIC Designation Category will correspond to its private letter rating).

- 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, but then must report it as NAIC 5GI thereafter (which has the equivalent of a NAIC 5.B RBC charge), if a report is still not provided.

The SVO has clarified that they expect the private rating rationale report to be comparable to public reports published for that same asset class and include an "analytical review of the privately rated security explaining the transaction structure, methodology relied upon, and, as appropriate, analysis of the credit, legal and operational risks and mitigants supporting the assigned NAIC CRP rating." The task force continued to address comments received and made updates during the summer related to confidentiality and operational issues leading up to final adoption of the amendment in July.

Credit tenant loans – In January 2021, the SAP Working Group adopted INT 20-10, Reporting Nonconforming Credit Tenant Loans (CTLs), that provided 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 a long-term solution, the VOS Task Force adopted in July an amendment to the SVO P&P Manual to update the definition of CTLs and ground finance leases to include only those in scope SSAP 37, Mortgage Loans, which would still be required to be filed with the SVO for an NAIC designation. Investments similar to CTLs and ground lease finance leases that are securities and that are in scope of SSAP 26R, Bonds, and SSAP 43R, Loan Backed and Structured Securities, would now become eligible for filing exemption and would not need to be filed with the SVO. Note the amendment did not update the residual asset exposure from the current 5% limitation.

During its August meeting the SAP Working Group also exposed for comment a proposal to nullify INT 20-10: Reporting Nonconforming CTLs, because it was a limited time exception that is no longer applicable with the revised definition. The regulators also exposed revisions to SSAP 43R for SVO-identified CTLs ahead of their principles-based bond proposal project. The proposed revisions explicitly address in the scope paragraph SVO-identified CTLs as in scope of SSAP 43R and removes CTLs as an example of "all other loan-backed and structured securities" from the designation guidance paragraph.

Working Capital Finance Investments – The task force adopted amendments to the P&P Manual to conform the WCFI guidance to reflect revisions adopted by the SAP Working Group to SSAP 105R including removal of certain investor representation requirements. They also exposed an amendment on whether the unrated, non-guaranteed subsidiary obligor of the program should or should not be assigned an NAIC designation based on implied support from its parent.

SVO on-going projects

Financially modeled securities – The SSG and the SVO received a letter from the ACLI and NASVA expressing concerns around the perceived "rushed implementation" of many of the changes to the reporting of financially modeled securities adopted in 2021 that they believe may bring unnecessary operational and reporting risks. The changes include the 20 new NAIC designation categories, changing from breakpoints to designations for non-legacy securities, changes to the bond RBC factors, and implementation of the zero-loss framework.

ACLI and NASVA are supportive of a phased-in approach and moving the implementation of the price points for the new 20 RBC designation categories into 2022 instead of year-end 2021. The SSG is in general agreement with a phased-in approach to allow more time for them to discuss these issues with the Valuation of Securities Task Force and run more scenarios. The SVO exposed the letter for comment. If the phased-in approach is adopted for year-end 2021 reporting, the NAIC designation for financial modeled securities would be mapped to the mid-point of the rating class, e.g., 1D, 2B, 3B, etc.

The task force's next meeting is scheduled for September 30; one proposed P&P amendment on the agenda is guidance that "zero-loss" financially modeled securities will be mapped to NAIC Designation Category 1A, which is a change from the 1.D rating used for year-end 2020.

Blanks Working Group

In addition to the adopted blanks changes discussed throughout this Newsletter, the working group adopted in May the following change to the 2021 annual statements and instructions. All adopted changes are summarized by the Blanks Working Group on their webpage.

- Add additional line categories on Schedule D Part 1 to capture collateral type data for all RMBS, CMBS and LBSS securities regardless of reporting category.

The working group also re-exposed for comment the following significant proposed revisions that have a comment deadline of October 22.

- Add a new supplement (due March 1) to the P/C Annual Statement (due March 1) to capture nine columns of premium and loss data for the "Other Liability" lines of business (Lines 17.1-17.3) of the Exhibit of Premiums and Losses to expand them into more granular classifications. There are 28 pre-populated lines of business (plus an "all other" classification) in the supplement along with accompanying definitions for a proposed year-end 2022 implementation (2021-13BWG). The supplement would apply to direct business only.

- Add a new supplement, Direct Premiums and Exposures, to the P/C Annual Statement to capture "direct exposures written" and "direct exposures earned" data for homeowners, private passenger auto no fault, private passenger liability and private passenger physical damage lines. Also add a new column to the quarterly statement Part 1 Loss Experience page for "direct exposures earned" and the Part 2 Direct Premium Written page for "direct exposures written" for those same lines (2021-11BWG).

The intent of the controversial proposal (drafted by the Center for Economic Justice) is to produce average written and average earned premium per exposure on a more timely basis to be used to analyze changes in average premium for residential property and personal auto insurance by state, with a suggested implementation date of year-end 2022. A primary rationale for including the data in the annual statement is that the current statistical report that discloses exposure information takes two years to compile and release.

Interested parties recommended that this proposal be rejected over concerns that it is statistical data and not appropriate for the annual statement, which is focused on financial data for solvency regulation. The Casualty Actuarial and Statistical Task Force also rejected the proposal in a 17-9 vote. Additional concerns were raised about the definition of "exposures" (e.g., a single residential property or single motor vehicle insured for a certain period of time), the view that this data is not currently readily available, and the significant time required to implement. The proposal was re-exposed for comment with a referral sent to CASTF, the Financial Analysis Working Group and Financial Analysis Solvency Tools Working Group for comment.

Financial Regulation and Accreditation Committee

The committee met as part of the Summer National Meeting and recommended as accreditation standards (with exposure for comment until January 1, 2022) the 2020 GCC-related revisions to the Insurance Holding Company System Regulatory Act (#440) and the Insurance Holding Company System Model Regulation with Reporting Forms and Instructions (#450). The proposed effective date for all states is January 1, 2026. The exposure is expected to be approved by the Executive Committee and Plenary at the Fall National Meeting.

Financial Stability Task Force

Liquidity Stress Test Framework
During its May meeting, the Financial Stability Task Force adopted the final 2020 Liquidity Stress Test Framework which is posted on its website, [2020 LST Framework with Lead State Guidance.]

The goal of the liquidity stress test is to allow regulators to "identify amounts of asset sales by insurers that could impact the markets under stressed environments" and is a life insurance-specific framework. The liquidity stress test includes a baseline, a financial crisis-like severely adverse stress scenario and an interest rate shock and downgrade stress scenario. The framework also requests insurer-specific information related to the most severe worst-case scenario used in an insurer's existing stress testing processes. The prescribed assumptions for the severely adverse stress scenario are based on the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule; however, a "what-if" modification has been added so that the insurer cannot use other internal and external funding sources such that expected asset sales would be the only source. Based on the scoping criteria adopted in 2018 ("material liquidity risk bearing activities"), 23 large life insurers are required to perform the stress testing for filing annually with their lead state regulator (after adoption by the lead state of the liquidity stress testing requirements in the 2019 revisions the Insurance Holding Company System Regulatory Act and Model Regulation).

Liquidity Assessment Subgroup
The Liquidity Assessment Subgroup has been repurposed into an ongoing group with broader responsibilities and has been renamed the Macroprudential Working Group. The working group has begun to work on its macroprudential risk assessment, which is a "risk dashboard outlining proposed risk categories, key risk indicators, and an assessment scale" as part of the NAIC's macroprudential surveillance system. No timeline on when the document would be exposed for comment was provided.

Climate risk

Climate Disclosure Workstream – The Climate Resiliency Task Force received a report from its Climate Risk Disclosure Workstream on the status of the NAIC's Climate Risk Disclosure Survey to be used for 2021, noting that 9 new states will participate in the survey this year, for a total of 15 participating states. (The new states are Delaware, District of Columbia, Maine, Massachusetts, Maryland, Oregon, Pennsylvania, Rhode Island, and Vermont.) The workstream chair noted that further Federal action is anticipated based on the climate-related goals of the Biden administration. The SEC recently announced plans to develop a mandatory climate risk disclosure proposal for comment by the end of the year, which would include industry specific metrics in certain cases, including insurance. It is not expected that the new disclosures would be effective for year-end Form 10-Ks.

Solvency Workstream – The Solvency Workstream held a meeting September 20 to discuss the approach of various state and Federal regulators relative to the solvency effects of climate change. This discussion included a presentation from the New York Department of Financial Services entitled "DFS's Approach to Solvency Risk," which included comments on NY Circular Letter 15 issued in 2020 and their related [public consultation], Proposed Guidance for New York Domestic Insurers on Managing the Financial Risks from Climate Change. The NYDFS representative stated that it is the goal of the DFS to finalize this guidance by the end of the year.

The regulators then asked for comments from industry and other interested parties; most industry commenters expressed concern about increases in regulatory requirements related to climate change when regulators currently have, in their opinion, adequate tools to assess solvency risk, such as ORSA and financial examinations. At the conclusion of the meeting the chair stated that the Solvency Workstream will be studying what enhancements should be made to currently-existing regulatory tools (such as ORSA) based on these discussions; the chair hopes to have an exposure draft for public comment in November.

Catastrophe Modeling Center of Excellence – The task force exposed for comment a proposal to create a Catastrophe Modeling COE at the NAIC, which is intended to help facilitate access to CAT modeling knowledge and expertise for insurance regulators. The COE, which would be led by the NAIC's Center for Insurance Policy Research would have three specific services:

- Facilitate insurance department access to and assistance in understanding catastrophe modeling
- Providing general technical training on the mechanics of CAT models and potential risks, and
- Conducting research analysis to proactively answer regulatory questions to inform regulatory resilience priorities

The purpose in creating this group would be to formalize the methods for insurance regulators to gain insight around catastrophe modeling and to help better understand the preparation for future climate changes and extreme weather events. The proposal was released for comment through October 21.

Report of the California Climate Insurance Working Group – At the Summer National Meeting, the task force heard a report from the California Climate Insurance Working Group, created in 2019 to examine issues related to climate change, resilience, and insurance, which recently released its report Protecting Communities, Preserving Nature and Building Resiliency, and which concludes that "the best long-term strategy is to drastically reduce greenhouse gas emissions." The report focuses on climate impacts from wildfire, extreme heat, and flooding and recommends increased risk assessment and communication through early warning systems, hazard mapping, and disclosure; risk reduction through better land-use, building practices and nature-based solutions; risk transfer through closing the protection gap using insurance, and innovative mitigation strategies. The working group believes that the recommendations are adaptable to all states and perils.

Group Solvency Issues Working Group

The working group has been focused on comments received on the recently exposed revisions to the NAIC's Financial Analysis Handbook, which are intended to incorporate elements of the IAIS' Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) deemed appropriate for the U.S. system of solvency regulation. Comments included what should be the scope of entities that the guidance should apply to; participants raised concern that the revisions did not adequately identify those entities, which could inadvertently impact the authority of state regulators. The working group agreed to look at clarifying language to address this issue.

Reinsurance Task Force

The task force met in July and discussed the Term and Universal Life Insurance Reserve Financing Model Regulation (#787) which becomes an accreditation standard on September 1, 2022. The task force received an update on the adoption of the standard, noting that as of June, five jurisdictions have adopted Model #787, with another six jurisdictions with action under consideration. Separately, there has also been significant progress in adoption of the revised Credit for Reinsurance Model Law and Regulation; as of September 1, 45 states have adopted model law, with NY and WI pending, and 17 states have adopted the revised Model Regulation with nine pending.

Principles-based reserving

Valuation Manual amendments
During LATF calls this spring and summer several APFs were discussed, exposed and/or adopted, the most notable being the following.

Adopted guidance
APF 2019-33 clarifies that group life contracts with individual life certificates meeting certain requirements are included in the requirements of VM-20. The changes will be applicable to policies issued on or after January 1, 2024.

APF 2020-10 allows application of a prudent assumption for mortality improvement beyond the valuation date, beginning with the 2022 Valuation Manual. Such assumptions will be guided by best-estimate future mortality improvement factors and margin recommended by the SOA and adopted by LATF. Future mortality improvement rates shall be 0% prior to adoption by LATF of the first set of future mortality improvement factors (see the next section for further details on development of these improvement factors).

For policies issued between 2017 and 2019 (i.e., the issue-year carveout from the YRT interim solution), the adopted proposal allows for phase-in of the current methodology for non-guaranteed YRT reinsurance with allowance for future mortality improvement. This APF was approved by the Executive Committee and Plenary at the Summer National Meeting, despite dissenting votes from NY, LA and NM.

Exposed guidance

APF 2019-34 proposed revisions introduce a new section in VM-30 to provide guidance specific to asset adequacy analysis for business under assumed or ceded reinsurance treaties, specifically that such business remains subject to the applicable valuation laws after reinsurance, and to clarify responsibilities of the appointed actuaries for both the ceding and assuming companies. The initial proposal targeted reporting for modified coinsurance agreements but based on regulator comments was broadened to address reinsurance in general.

APF 2020-12 proposed changes would create consistency between clearly defined hedging strategy (CDHS) modeling requirements in VM-20, PBR Requirements for Life Products, and VM-21, PBR Requirements 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. The latest exposure clarifies application of the guidance. The extent of industry questions on the scope of the amendment resulted in formation of a regulator drafting group to initiate discussions with companies to better understand the underlying issues.

Future exposure

Future mortality improvement assumption – At the Summer National Meeting LATF members discussed the future mortality improvement (FMI) assumption that could be applied under the recently adopted APF 2020-10, which allows application of a prudent assumption for mortality improvement beyond the valuation date, beginning with the 2022 VM. 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 (best-estimate) and loaded FMI scales.

The proposed framework would allow for FMI scale factors to be applied for up to 20 years beyond the valuation 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. The presentation included estimated impacts on reserves from application of best-estimate and loaded FMI scale factors, where the recommended loading is a flat 25% reduction in the FMI scale factors.

During the presentation LATF members questioned the development of the estimated reserve impacts, the basis for the 25% loading recommendation, and the potential need to develop FMI scales that vary by geographic area and/or type of underwriting. Presenters noted conservatism in the estimates, which are based on general population data rather than insured data, and plans to incorporate COVID-19 impacts once 2020 historical data are included in the experience. No further action was taken and discussion on this topic will continue on a future LATF call.

Other VM Project Updates

VM-22 - PBR for fixed annuities – LATF heard an update from the VM-22 Subgroup on activities related to fixed annuity PBR. The subgroup has held numerous calls to discuss the Academy Annuity Reserves and Capital Work Group (ARCWG) proposed framework, "Preliminary Framework Elements for Fixed Annuity PBR," during which they primarily discussed aggregation considerations and the descriptions of the income (i.e. payout) and deferred (i.e. accumulation) annuity reserve categories. These calls culminated with the exposure of the initial draft of NAIC Valuation Manual Section II and VM-22 requirements associated with the ARCWG proposal, which is exposed until October 19.

On several calls subgroup members debated whether to define the reserve categories using prescriptive criteria to identify contracts considered to be payout annuities (with all other contracts considered to be deferred annuities) or principle-based criteria referencing supporting assets and relative assessment of risks associated with disintermediation, policyholder behavior and longevity. Unable to reach consensus on this matter, the two alternative approaches are included in the exposure along with a list of issues in which the subgroup is especially interested in comments.

A VM-22 field test is targeted for May 2022 through September 2022, but the exact timing depends on the timing of the ESG field test. The target date for implementation of the VM-22 PBR requirements remains January 1, 2024.

Life Actuarial Task Force

ESG implementation project
The goal of this critical project is to produce "real-world interest and equity scenarios" to be used in calculations required by VM-20 and VM-21 and RBC under C3 Phase 1 and Phase 2. In response to concerns raised by industry members and interested parties with respect to the proposed ESG project timeline, lack of transparency in the work, and lack of opportunity for specific industry input to the process, the LATF and Life RBC Working Group chairs issued a memorandum in May addressing these concerns. The communication noted the NAIC's commitment to "producing a working ESG that meets the expectations of both the regulatory and interested party communities," and confirmed there will be no field test in 2021 and the ESG will not be ready for implementation as of January 1, 2022, although no specific timeframe for completion was noted. The communication also noted that any recommendations from the ESG Drafting Group would be discussed on open calls with opportunity for industry input, and that progress updates will be provided to interested parties on a regular basis. There are also plans to reach out to the Academy and ACLI to provide more meaningful input and expert advice to the ESG Drafting Group.

At the Summer National Meeting LATF heard an update from the ESG Drafting Group on recent activity. The drafting group's immediate focus is to develop a set of recommendations for the GEMS Treasury Model and an associated set of scenarios for consideration by LATF and the Life RBC Working Group. Group meetings are currently focused on reviewing scenario output from multiple iterative recalibrations of the GEMS ESG to arrive at a recommendation for field testing. The presentation included key goals for calibration of the new treasury model and a summary of ESG impacts and tradeoffs for specific target metrics and economic conditions.

Index-Linked Variable Annuity Subgroup
In June LATF members established the Index-Linked Variable Annuity Subgroup, which has a single charge to "provide recommendations and changes, as appropriate, to nonforfeiture, or interim value requirements related to Index-Linked Variable Annuities" (ILVA). Regulators have identified ILVAs as an emerging product that does not fall neatly into existing regulations for indexed annuities or variable annuities and established the ILVA Subgroup to establish draft standards for minimum values. The subgroup held its first call in June and discussed options for ILVA interim values, which will be discussed during their September 23 conference call. The subgroup hopes to present a recommendation to LATF at the Fall National Meeting.

Long-term care issues

Long-Term Care Insurance (EX) Task Force

During the Summer National Meeting the task force heard updates from its subgroups on their assigned projects.

Financial solvency concerns – This subgroup is responsible for overseeing the reserve and solvency status of companies with major LTC blocks. The subgroup annually reviews the AG 51 (Application of Asset Adequacy Testing to LTCI Reserves) submissions and provides feedback to the states and NAIC. While the focus of the 2019 submissions was on investment return and incidence improvement, the focus of the 2020 submissions was on the variation of the cost of care. Company considerations of various external trends were also analyzed, in particular COVID and the baby boomer influx (which is changing how and where people utilize care).

Multi-state rate review practices – The goal of this workstream is to develop a recommendation for a consistent national approach to multi-state LTCI rate reviews. The workstream members have received public comments on the actuarial aspects of an initial draft multi-state rate action (MSA) framework. These comments are being considered and the framework continues to be refined.

Reduced benefits options (RBO) – This subgroup is focused on information gathering on practices for the state regulatory review of reduced benefit options in lieu of premium increases, and consumer notices sent by companies. The subgroup will also evaluate whether reduced benefit options offered to consumers are fair and equitable. The subgroup also drafted a consumer notices checklist, aimed at a consistent approach to drafting and reviewing RBO communications. The checklist is considered best practice guidance, and not a requirement. The subgroup is working toward finalization of the checklist this fall.

The subgroup published an issues paper related to LTC wellness benefits in July. The focus of the paper is what companies should consider before implementing a wellness program, one company's experience with such wellness programs and lessons learned, and how to prevent unfair discrimination practices.

LTC Rate Review Multi-state Framework – There are two aspects to the framework: operations and actuarial, and the former is more fully developed. Recent revisions include clarification of what information will be confidential versus public; currently the laws of each state generally dictate the level of confidentiality. Also discussed was what type and level of detailed information will be provided to the insurer for the filing. The expectation is the new framework will be iterative and the balance between transparency and protecting sensitive information will be refined.

The MSA Framework Drafting Group has heard comments that more insurers and states need to be involved in the framework. An MSA associate program has been created in an effort to get more states involved in the review process, which includes a mentorship program aimed at increasing state level expertise. A sample advisory report has been created, which can be customized to the facts and circumstances of each individual rate filing.

LTC Insurance Model Update Subgroup – 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. During its July meeting, the subgroup heard presentations from the Interstate Insurance Product Regulation Commission, the ACLI, the Nebraska Insurance Department and a consumer group, the California Health Advocates on the current LTCI marketplace and "what products are being seen, filed and produced in the marketplace."
Discussion topics included the proposed Federal WISH Act (which would provide catastrophic long-term care coverage) and enacted public programs in Washington State and California and whether and how these programs link up with the private marketplace. The subgroup also discussed how to encourage more industry activity through public partnership programs, innovative products, removing the lack of rate uniformity

across states, improving consumer knowledge, and expanding carrier options in managing existing blocks of business.

Annuity suitability

Following the adoption of the revised Suitability in Annuity Transactions Model Regulation (#275) which added a best interest standard of conduct, states have started the process of adopting the new regulation. To assist state regulators with informing their legislators about the revisions, the Annuity Suitability Working Group and the Life and Annuities Committee adopted an FAQ document this summer, with a goal of promoting greater uniformity across NAIC member jurisdictions.

International Insurance Relations Committee

The committee heard an update on international projects in process.

IAIS update

The IAIS is continuing its 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, targeted jurisdictional assessment, has commenced; the U.S. is participating in the assessment, which is expected to conclude next year and include assessment of whether to continue with the G-SII process.

Work continues on assessing the Aggregation Method (AM) and data for the monitoring period is being collected now to develop draft criteria for assessing comparability of the AM developed by the U.S. to the Insurance Capital Standard. The Global Monitoring Exercise, another component of the Holistic Framework, is underway and data is being reviewed as part of individual insurer and sector wide monitoring to develop the scope of discussions on collective systemic risks which is expected to take place this fall.

The International Insurance Relations Committee reviewed and provided comments on the IAIS draft application paper on Macroprudential Supervision primarily related to the paper's focus on an entity- based approach as opposed to an activities-based approach to systemic risk in the insurance sector.

Mortgage guaranty insurance issues

The Mortgage Guaranty Issues Working Group achieved its goal of adoption of a new supplemental annual Mortgage Guaranty Insurance Exhibit, which very significantly expands disclosures of mortgage guaranty insurance specific information, effective beginning year-end 2021, and due each April 1. The new 8-page schedule will disclose premium, claims and LAE data by year the policies are written in a format similar to Schedule P, separated into two classes of business: 1) primary flow and bulk business and 2) pool business. The proposal (2021-08BWG) was adopted by the Blanks Working Group in May, which included several "friendly amendments" to the proposal drafted by the MG Insurance Working Group.

The working group still has the charge to develop changes to the Mortgage Guaranty Insurance Model Act (#630), but has not met in 2021 to work on that project.

The 2021 Fall National Meeting of the NAIC is scheduled for December 13-16 in San Diego. 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.

Newsletter Disclaimer

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

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

Appendix A

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

Issue/ Reference #	Status	Action Taken/Discussion	Proposed Effective Date
SSAP 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 late 2021 or 2022.	TBD
SSAPs 68 & 97 – Goodwill (#2019-12 and #2019-14)	Discussion deferred	There has been no discussion of these goodwill-related projects since 2019, presumably due to work on other higher profile projects. The SAPWG webpage states the working group has "deferred discussion of this agenda item for a subsequent call or meeting."	TBD
SSAP 43R – Revised Issue Paper (#2019-21)	Exposed	The working group adopted a preliminary bond definition framework to better clarify what should be considered a bond (whether captured in SSAP 26R or SSAP 43R) and reported on Schedule D-1. See further discussion above in the summary of the SAP Working Group.	TBD
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 the Schedule P reporting, which could result in revisions to SSAP 62R to "clarify Schedule P expectations." The working group received an update at the Spring 2021 National Meeting, noting that discussions with the Casualty Actuarial Task Force are on-going.	TBD
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. There has been no discussion of this issue in 2021.	TBD

SSAPs 86 & 108 – Derivatives Hedging Fixed Indexed Products (#2020-36)	Re-exposed	The working group had exposed an initial proposal for establishing accounting and reporting guidance for derivatives hedging the growth in interest for fixed indexed products. During its May 2021 meeting, the working group sent a referral to the Life Actuarial Task Force, seeking input regarding whether the task force would consider changes to the reserve framework of fixed annuity products, as their response "will likely directly influence the accounting options for derivatives hedging these products."	TBD
SSAP 56 – Separate Accounts (#2020-37) and Pension Risk Transfer (#2020-38)	Adopted	In response to the recent growth of pension risk transfer transactions and registered indexed-linked annuity products, the working group adopted these agenda items to support disaggregated product identifiers disclosures in the general interrogatories. This does not result in statutory revisions but is reflected in the related Blanks proposal 2021-03BWG adopted by the Blanks Working Group.	Year-end 2021 Life annual statements
SSAP 86 – Reference Rate Reform (#2021-01)	Adopted	The SAP Working Group adopted revisions for a temporary (optional) expedient and exception guidance for ASU 2021-01, Reference Rate Reform with an expiration date of December 31, 2022. See further discussion in the SAPWG summary above.	January 1, 2021
SSAP 26R – Receivables (#2021-02)	Adopted	The regulators adopted a previously exposed proposal to reject ASU 2020-08, Codification Improvements to Subtopic 310-20, Receivables – Nonrefundable Fees and Other Costs for statutory accounting.	May 20, 2021
SSAP 103R – Transfers of Assets (#2021-03)	Adopted	The SAP Working Group adopted new disclosures for securitizations and similar transfers accounted for as sales when the transferor has continuing involvement. They also adopted a data-capture template for certain existing disclosures in SSAP 103R, which is adopted as 2021-05BWG.	December 31, 2021
SSAP 97 – Investments in Subsidiaries (#2021-04)	Adopted	The SAP Working Group adopted revisions to SSAP 97, which will limit statutory adjustments for foreign insurance SCAs, resulting in a valuation floor of zero if the entity is not engaged in providing services to, or holding assets on behalf of, the U.S. insurance company parent or its affiliates. Revisions also include a clarification that the equity method valuation referenced in SSAP 97 can result in a negative equity valuation for SSAP 48 entities.	August 26, 2021
SSAP 2R – Cash & Cash Equivalents (#2021-05)	Adopted	The SAP Working Group adopted revisions that cryptocurrencies do not meet the definition of cash and that direct investments in such currencies are nonadmitted assets for statutory accounting.	May 20, 2021

Appendix D – GAAP cross reference to SAP (#2021-07)	Adopted	The working group adopted revisions to reject ASU 2020-11, Financial Services—Insurance (Topic 944): Effective Date and Early Application for statutory accounting.	May 20, 2021
SSAP 47 – Uninsured Plans (#2021-08)	Adopted	The regulators adopted a previously exposed proposal to reject ASU 2021-02, Franchisors–Revenue from Contracts with Customers.	May 20, 2021
SSAP 107 – Affordable Care Act (#2021-09)	Exposed	The SAP Working Group proposed guidance for State ACA reinsurance programs, which are using Section 1332 waivers, to apply the guidance of SSAP 107. See further discussion in SAPWG summary above.	TBD
SSAP 32R – Preferred Stock (#2021-10)	Adopted	The working group adopted previously exposed revisions to SSAP 32R to clarify that the effective call price valuation limitation shall only apply if the call is currently exercisable by the issuer or if it has been announced the instrument will be redeemed or called.	August 26, 2021
SSAP 43R – Credit Tenant Loans (#2021-11)	Exposed	As part of its joint work with VOS Task Force on CTLs, the SAP Working Group exposed for comment the following actions: 1) nullify INT 20-10, 2) dispose item #2020-24 on CTLs with no statutory revisions, and 3) proposed revisions to SSAP 43R to explicitly identify the SVO-identified CTLs in scope of SSAP 43R. See the summary of the VOSTF above for additional discussion.	TBD
SSAP 55 – Unpaid Claims, Losses and Loss Adjustments Expenses (#2021-13)	Exposed	The working group exposed nonsubstantive revisions to SSAP 55 to clarify that salvage and subrogation estimates and recoveries can include amounts related to both claims/losses and loss adjusting expenses (LAE). The corresponding estimates should be reported as a reduction of losses and/or LAE reserves.	TBD
NAIC Policy Statement – Terminology (#2021-14)	Exposed	The SAP Working Group received a referral from the Financial Condition Committee, to clarify the statutory accounting terminology of "substantive" and "nonsubstantive" to describe statutory accounting revisions being considered by the working group. See further discussion in the SAPWG summary above.	TBD
SSAP 43R – Residual Tranches (#2021-15)	Exposed	The working group exposed revisions to clarify that non-rated residual tranches shall be reported on Schedule BA – Other Long-Term Investments and valued at the lower of cost or fair value. Refer to the SAPWG Summary above for additional detail.	TBD
SSAP 6 – Amounts Due from Agents (#INT 21-02T)	Exposed	The SAP Working Group proposed a temporary, optional extension to the "90-day rule" in SSAP 6 for polices impacted by Hurricane Ida (consistent with other nationally significant disasters). The temporary extension is proposed to automatically nullify on January 24, 2022.	TBD

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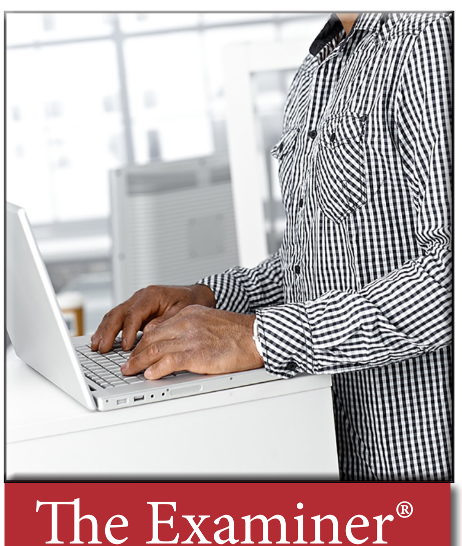
Omni Louisville

2024 July 28-Aug. 1
Oklahoma City, OK
Omni Oklahoma City Hotel





Upcoming deadline for article submissions:

2022 Spring Issue: February 7, 2022

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

Interested authors should contact the Publications Committee Co-Chairs, **Joanne Smith or Robin Roberts**, via sofe@sofe.org.

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