



**NATIONAL MEETING
SPRING 2022**

Date: 3/17/22

*Virtual Meeting
(in lieu of meeting at the 2022 Spring National Meeting)*

LIFE RISK-BASED CAPITAL (E) WORKING GROUP

Wednesday, March 23, 2022

12:00 – 1:00 p.m. ET / 11:00 a.m. – 12:00 p.m. CT / 10:00 – 11:00 a.m. MT / 9:00 – 10:00 a.m. PT

ROLL CALL

Philip Barlow, Chair	District of Columbia	William Leung	Missouri
Jennifer Li	Alabama	Derek Wallman	Nebraska
Thomas Reedy	California	Seong-min Eom	New Jersey
Wanchin Chou	Connecticut	Bill Carmello	New York
Sean Collins	Florida	Andrew Schallhorn	Oklahoma
Vincent Tsang	Illinois	Mike Boerner/ Rachel Hemphill	Texas
Mike Yanacheak/ Carrie Mears	Iowa	Tomasz Serbinowski	Utah
Fred Andersen	Minnesota		

NAIC Support Staff: Dave Fleming

AGENDA

1. Consider Adoption of its March 10, 2022; Jan. 20, 2022; Dec. 16, 2021; and 2021 Fall National Meeting Minutes—*Philip Barlow (DC)* Attachments A–D
2. Discuss its Working Agenda—*Philip Barlow (DC)* Attachment E
3. Discuss Reinsurance and Comfort Trusts—*Philip Barlow (DC)* Attachments F and G
4. Discuss Bond Funds—*Philip Barlow (DC)* Attachment H
5. Discuss Any Other Matters Brought Before the Working Group —*Philip Barlow (DC)*
6. Adjournment

[Agenda LRBC 3-23-22.docx](#)

Draft: 3/20/22

Life Risk-Based Capital (E) Working Group
Virtual Meeting
March 10, 2022

The Life Risk-Based Capital (E) Working Group of the Capital Adequacy (E) Task Force met March 10, 2022. The following Working Group members participated: Philip Barlow, Chair (DC); Jennifer Li (AL); Thomas Reedy (CA); Wanchin Chou (CT); Mike Yanacheak and Carrie Mears (IA); Ben Slutsker (MN); William Leung (MO); Derek Wallman (NE); Seong-min Eom (NJ); Bill Carmello (NY); Mike Boerner and Rachel Hemphill (TX); and Tomasz Serbinowski (UT).

1. Discussed the American Academy of Actuaries' (Academy) C2 Mortality Work Group Recommendation

Mr. Barlow said there was one comment letter received. Brian Bayerle (American Council of Life Insurers—ACLI) presented the ACLI's comment letter (Attachment One). He said the ACLI has one main recommendation with respect to the tiered charges and is suggesting treatment similar to what is currently done for disability income where the product category with the highest risk charges is considered first, followed by the product category with the next highest risk charges but with recognition of the amount of net amount at risk (NAR) in the first category before determining which tiered charge to use. The third product category would then consider the NAR in the first two categories. Mr. Bayerle also noted the ACLI's request for greater clarification of the definitions and improved tie-outs. He said the ACLI has a preference for option one in the Academy's recommendation (Attachment Two) because of greater transparency. Mr. Barlow asked if the ACLI would be supportive if the suggested alternative tiering resulted in higher factors. He said it appears the ACLI is supportive of having amounts objectively pulled from the annual statement but asked for clarification if the ACLI was suggesting changes to the way certain items are reported. Mr. Bayerle said the ACLI would need to review any change in the proposed factors because of a change in the proposed tiering but consistency with the analysis would be preferable. With respect to reporting changes, he said changes might be straightforward and, if regulators think this is a good idea, it might make sense as an area to explore in order to get direct tie outs but that it appears that is something to be considered for 2023. Mr. Slutsker expressed appreciation for the ACLI's suggestion on tiering as he believes it addresses the risk on a more objective measure rather than reliance on the name of a product group. Chris Trost (Academy), chair of the Academy C2 Mortality Work Group, said the Work Group has already done some preliminary work on this suggestion but said the proposed tiering was just to recognize that the volatility risk declines the bigger the block size is, so it makes sense to look at the aggregate mortality exposure as opposed to the break points for each of the categories. He said the Work Group is planning to respond to this suggestion, along with other comments made previously, formally so it can be considered by the Working Group on a future call. Mr. Slutsker said he appreciates the desire to be able to tie out to amounts from the annual statement but also appreciates the appeal of option two and asked if something similar to option two was done with the adoption of the longevity risk charges. Paul Navratil (Academy), chair of the Academy's C-2 Longevity Risk Work Group, said longevity risk RBC treatment referred to reserves in the annual statement but on an in-part basis because not all products aggregated in a single line were in scope and company records were needed. Mr. Barlow asked if there is a desire to go with option two and adjust the reporting in the annual statement. Mr. Bayerle asked which option the factors were based on. Mr. Trost said option two is offered because it is more of a principle-based approach, but it will require companies to populate the exposure for the different categories. He said the key aspect is the adjustment capacity and option two involves more intensive categorization which would require underlying calculations by companies. While option one is also based on company records, he said it is more explicit as there is already a basis in the annual statement for the different categories.

With both options using company records and possible adjustments to the annual statement reporting, with option two perhaps being more involved, Mr. Barlow said it appears there is a desire to move forward with one of the two options for 2022 RBC with reporting changes in 2023 to reduce the reliance on company records. He suggested considering longevity when thinking about the reporting changes to possibly lessen the reliance on company records for that RBC item as well. With a requirement to adopt the structural changes by the end of April for 2022 yearend RBC, he asked if both options offer the same ability to address issues. Mr. Trost said he believes the Working Group could adopt either option for the structure, and it will be a matter of modifying the definition of categories in the instructions. He said the Academy would like to address that along with previous questions and present it to the Working Group, but this could be done on a call prior to the end of April. Mr. Barlow asked if another exposure of the structural changes would be needed before the end of April. Dave Fleming (NAIC) said, while there are some differences between structural presentation of the two options, they are line-item descriptions so he does not believe an additional exposure of the structure would be needed. He said there is time for the Working Group to have one call in April to hear additional input from the Academy and then another call to adopt the structural changes if two calls are needed. Mr. Barlow said the Working Group will schedule a call when the Academy has their updated information. Mr. Leung asked if the Academy will be able to provide the annual statement changes contemplated for both options. Mr. Trost said he believes they could include that in their update but will discuss it with the Academy Work Group.

2. Exposed the Asset Valuation Reserve Changes for Comment

Mr. Fleming reminded the Working Group that the changes being proposed to the asset valuation reserve (AVR) are a result of the changes to the RBC bond factors adopted for yearend 2021 and, as was done with RBC changes done for tax reform, these changes are mechanical and to retain the existing relationships. He said it starts with the AVR maximum reserve factor which is to equal the after-tax RBC factor and the AVR basic contribution and reserve objective factors are then percentages of the maximum reserve. He said these changes will be exposed for comment by the Blanks (E) Working Group at their Spring National Meeting and considered for yearend 2022 implementation. He said the Working Group does not need to adopt this proposal but suggested a short exposure by the Working Group to address any technical comments and, while none are expected, any comments received can be addressed as a modification to the Blanks (E) Working Group exposure. The Working Group agreed to expose the changes to the AVR (Attachment Three) for a comment period ending March 25.

Having no further business, the Life Risk-Based Capital (E) Working Group adjourned.

[Att Life RBC 3-10-22 Minutes.docx](#)

Draft: 3/20/22

Life Risk-Based Capital (E) Working Group
Virtual Meeting
January 20, 2022

The Life Risk-Based Capital (E) Working Group of the Capital Adequacy (E) Task Force met Jan. 20, 2022. The following Working Group members participated: Philip Barlow, Chair (DC); Jennifer Li (AL); Thomas Reedy (CA); Wanchin Chou (CT); Sean Collins (FL); Mike Yanacheak and Carrie Mears (IA); Vincent Tsang (IL); Ben Slutsker (MN); William Leung (MO); Derek Wallman (NE); Seong-min Eom (NJ); Bill Carmello (NY); Mike Boerner and Rachel Hemphill (TX); and Tomasz Serbinowski (UT).

1. Discussed Comments Received on the American Academy of Actuaries' (Academy) C2 Mortality Work Group Recommendation

Brian Bayerle (American Council of Life Insurers—ACLI) presented the ACLI's comment letter (Attachment One) and said the ACLI is generally supportive of an update to the mortality factors. He highlighted the ACLI's desire for more analysis on the risk exposure periods and the ability of companies to adjust the mortality rate for emerging experience along with greater analysis on the margins. Mr. Slutsker presented Minnesota's comments (Attachment Two) highlighting a request to the Academy to reflect additional uncertainty on future mortality in light of COVID-19. He also noted the Academy's current proposed category breakdown and Minnesota's recommendation to have the categorization done based on guarantee duration similar to how valuation rates are assigned in the Standard Valuation Law. Additionally, he noted Minnesota's suggestion to determine the C-2 mortality component based on the underlying guarantee duration in the policy with appropriate adjustments for certain types of policies. Mr. Barlow said he believes the categorization is a topic that will require more discussion but his hope is that it can be aligned with how information is presented in the annual statement to make it as objective as possible. Chris Trost (Academy) said there is always the challenge of relying on what is available in the annual statement versus more of a principles-based approach and having companies putting products into specific categories based on their analysis. He said the reason the Academy chose the categories in the recommendation is they most closely follow the information in the annual statement and for principle-based reserves as well. While acknowledging that there will always be some imperfections, he said the Academy believes the higher level of differentiation is appropriate. He also commented that, with respect to questions about pandemics, and specifically COVID-19, the Work Group did add a component for an unknown sustained type of risk establishing a 2.5% annual probability that such an event can occur with a 5% severity so mortality rates would be 5% higher and that would last for either the exposure period or for ten years. He said the Academy could provide additional sensitivities around those assumptions to show the impact on factors. Mr. Carmello spoke to New York's comments (Attachment Three) and highlighted New York's focus on the current pandemic and their concern that it may not be reflected sufficiently in the development of the proposed factors. He said he supports having more sensitivity tests included for the Working Group's consideration. To New York's comment on mortality improvement, Mr. Trost said the Academy could also provide sensitivities on that as well.

Mr. Barlow said it appears the two primary issues are the factors and the categorization and asked if changes to the categorization would be a structural change. Dave Fleming (NAIC) said the categorization could change the structural presentation, but that presentation can be modified as a result of comments received from the exposure. He noted that the instructions, which include the factors, are included for information only, are not final and are subject to a later exposure deadline. The Working Group agreed to expose the Academy's proposed structural changes (Attachment Four) for a comment period of 45 days.

2. Discussed the Academy's Comment Letter on Longevity Reinsurance

Mr. Barlow thanked Ms. Eom for volunteering to chair the Longevity Risk (E/A) Subgroup and reminded Working Group members that the Subgroup's work is pending some of the work on the reserve side. Paul Navratil (Academy), chair of the Academy's C-2 Longevity Risk Work Group, said the purpose of the Academy's comment letter (Attachment Five) is to continue the conversation, knowing that longevity reinsurance remains an item to be addressed by the Working Group, and to make the connection with VM-22 and consistency between the reserve work and what is ultimately done for capital.

3. Discuss the Asset Valuation Reserve and Bond Factor Changes

Mr. Barlow reminded the Working Group that changes to the asset valuation reserve (AVR) need to be made to correspond to the changes to the bond factor changes. Mr. Fleming said, as was done with the changes to AVR related to the RBC changes for tax reform, these changes are largely mechanical and to retain the existing relationships. He said these are changes that will need to be adopted by the Blanks (E) Working Group and that he has been working with the ACLI to draft these to meet the needed timeline for yearend 2022 implementation.

Having no further business, the Life Risk-Based Capital (E) Working Group adjourned.

[Att Life RBC 1-20-22 Minutes.docx](#)

Draft: 3/16/22

Life Risk-Based Capital (E) Working Group
Virtual Meeting
December 16, 2021

The Life Risk-Based Capital (E) Working Group of the Capital Adequacy (E) Task Force met Dec. 16, 2021. The following Working Group members participated: Philip Barlow, Chair (DC); Charles Hale (AL); Thomas Reedy (CA); Wanchin Chou (CT); Sean Collins (FL); Mike Yanacheak (IA); Vincent Tsang (IL); Fred Andersen (MN); William Leung (MO); Derek Wallman (NE); Seong-min Eom (NJ); Bill Carmello (NY); Andrew Schallhorn (OK); Mike Boerner and Rachel Hemphill (TX); and Tomasz Serbinowski (UT).

1. Adopted the Guidance Document on Bond Factor Changes

Brian Bayerle (American Council of Life Insurers—ACLI) said the ACLI believes the document will be helpful to state insurance regulators and supports its adoption with the inclusion of the reference to other changes made for year-end 2021.

Mr. Yanacheak made a motion, seconded by Mr. Leung, to adopt the Working Group's guidance document on bond factor changes (Attachment **One**). The motion passed unanimously.

2. Discussed the Report of the Academy C2 Mortality Work Group

Chris Trost (American Academy of Actuaries—Academy), chair of the Academy C2 Mortality Work Group, highlighted the main change the Academy is recommending: to expand the number of categories in the current structure that applies a factor to the net amount at risk (NAR), which decreases as the NAR increases. The Academy believes a critical element in capturing the risk is the length of the exposure period, where there is not the capacity to adjust the mortality charges; and because of that, he said the Academy created three categories using VM-20, Requirements for Principle-Based Reserves for Life Products, as a guide with term, universal life with secondary guarantees (ULSG), and all other. The all other category maintains the same period that the original risk-based capital (RBC) work used, which is looking at the mortality risk over a five-year period because beyond that time, the risk could be covered through adjustments and mortality rates. Mr. Trost said the exposure period lasts much longer for term and ULSG, and the Academy used averages of 10 years for term and 20 years for ULSG. He said the Academy also added a catastrophe terrorism component and a catastrophe unknown sustained risk component. He discussed other aspects that were changed and those that were not changed, as shown on page 6 of the recommendation (Attachment **Two**). Ryan Fleming (Academy) presented the updated C-2 factors, other aspects of the categorization, and a comparison of the recommended factors versus the current factors, along with the percentage change in those factors. He discussed the C-2 factors as an overall mortality increase, along with the Academy's comparison against other capital regimes. He highlighted the Academy's sensitivity testing, which helped in identifying that the length of the mortality rate exposure period is one of the most critical variables in determining capital factors. He summarized the Academy's recommendation and noted that the Academy does not believe additional review of the adopted correlation factor with longevity is needed, as the work on mortality was done consistently with the longevity work.

With respect to the Academy's pandemic modeling, Ms. Hemphill noted what appeared to be one-year events, and she asked whether having another component to account for multi-year events was considered. Mr. Trost said the Academy was capturing a multi-year event but modeling it occurring in one year. He also noted that the Academy looked at the actual impacts of unknown sustained risks, specifically with the opioid epidemic and AIDS,

and those impacts were significantly less in the insured population than the general population, but the Academy did not reflect this in its recommendation. For those sustained type risks, he said the Academy also included the assumption that the worst experience was the same at all ages, which adds another level of conservatism. Ms. Hemphill expressed concern with the factor decrease for the all other category, given how non-homogenous the products are in the ability to adjust, and she suggested the possibility of addressing this either through revising the factors presented or adding some regulatory review process. Mr. Carmello suggested having products without the ability to adjust default the categories with higher factors and not the all other category. Mr. Barlow said another approach could be to set the factors for the all other category to whatever is appropriate for the product involving the most risk.

Mr. Barlow said the Academy will work with NAIC staff on the needed structural changes so they can be exposed for comment before the end of January.

Having no further business, the Life Risk-Based Capital (E) Working Group adjourned.

[Att Life RBC 12-16-21 Minutes.docx](#)

Draft Pending Adoption

Attachment **XX**
 Capital Adequacy (E) Task Force
 --/--/21

Draft: 12/8/21

Life Risk-Based Capital (E) Working Group
 Virtual Meeting *(in lieu of meeting at the 2021 Fall National Meeting)*
 November 9, 2021

The Life Risk-Based Capital (E) Working Group of the Capital Adequacy (E) Task Force met Nov. 9, 2021. The following Working Group members participated: Philip Barlow, Chair (DC); Jennifer Li (AL); Ben Bock (CA); Wanchin Chou (CT); Sean Collins (FL); Carrie Mears (IA); Vincent Tsang (IL); Ben Slutsker (MN); William Leung (MO); Derek Wallman (NE); Seong-min Eom (NJ); Bill Carmello (NY); Andrew Schallhorn (OK); Mike Boerner and Rachel Hemphill (TX); and Tomasz Serbinowski (UT).

1. Adopted its Summer National Meeting minutes

Mr. Chou made a motion, seconded by Mr. Schallhorn, to adopt the Working Group's July 21 *(see NAIC Proceedings – Summer, Capital Adequacy (E) Task Force, Attachment Four)* minutes. The motion passed unanimously.

2. Exposed the Guidance Document on Bond Factor Changes

Mr. Barlow said this was directed to NAIC staff to draft in order to assist financial examiners and other state insurance regulators as they review the results of 2021 risk-based capital (RBC) calculations for life insurers in light of the 2021 bond factor changes. The Working Group exposed the guidance document for a 30-day public comment period ending Dec. 9.

3. Exposed the Report of the C2 Mortality Work Group of the Academy

Chris Trost (American Academy of Actuaries—Academy), chair of the Academy's C2 Mortality Work Group, said the last time the Work Group was able to provide a report was last year due to the focus on bonds, real estate, and longevity this year. He said the Work Group has continued its work and, where previous updates have been focused on methodology, the Work Group is now at a point to present its recommendations (Attachment Three-A). He noted that included with the recommendations is a full report (Attachment Three-B) that highlights the major changes in the proposed methodology along with detailed documentation on the methodology and assumptions. He said the Work Group is looking for additional feedback, questions, and any other information the Working Group would like to have provided.

Ryan Fleming (Academy) presented the recommendations. Discussing the overall framework and the mortality risk categories, he noted that while the previous recommendation included catastrophe risk, the Work Group has included two new components, one for a terrorism-type event as well as providing for some chance of a currently unknown event. Mr. Carmello asked about the work done for the original factors and suggested it was not stochastic. Mr. Fleming said it was a more limited number of potential scenarios related to various adverse events and did not involve running thousands of scenarios and getting a full distribution of results. Mr. Carmello said it appears these were more deterministic scenarios. Mr. Fleming highlighted what had changed in the recommendation from the original work and what had not as presented on slide six and noted that the expanded factor categories for both individual and group life are needed to reflect differences in mortality risk. He continued this aspect with the information in slides nine and 10, highlighting the relative contribution of the risk categories to the overall capital factors and noting that those factors should recognize that there are varying levels of flexibility to adjust premiums or mortality charges between the products.

The Working Group agreed to expose the Academy's recommendations and report for a public comment period ending Jan. 10, 2022. Mr. Barlow suggested scheduling a meeting to continue discussion of this recommendation during the exposure period and asked Mr. Trost to work with NAIC staff on drafting the actual blank and instructions necessary for a formal proposal.

4. Discussed Other Matters

Mr. Barlow reminded the Working Group that there is work being done by the American Council of Life Insurers (ACLI) on making the necessary modifications to the asset valuation reserve (AVR) factors related to the bond factor changes. He also

Draft Pending Adoption

Attachment **XX**
Capital Adequacy (E) Task Force
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noted that Dave Fleming (NAIC) has continued work on the statistics review and that the goal is to have this presented to those Working Group members who volunteered in December.

Having no further business, the Life Risk-Based Capital (E) Working Group adjourned.

| [Att D Life RBC 11-9-21 Minutes.docx](#)

2022 #	Owner	2022 Priority	Expected Completion Date	Working Agenda Item	Source	Comments	Date Added to Agenda
Ongoing Items – Life RBC							
1	Life RBC WG	Ongoing	Ongoing	Make technical corrections to Life RBC instructions, blank and /or methods to provide for consistent treatment among asset types and among the various components of the RBC calculations for a single asset type.			
2	Life RBC WG	1	2022 or later	1. Monitor the impact of the changes to the variable annuities reserve framework and risk-based capital (RBC) calculation and determine if additional revisions need to be made. 2. Develop and recommend appropriate changes including those to improve accuracy and clarity of variable annuity (VA) capital and reserve requirements.	CATF	Being addressed by the Variable Annuities Capital and Reserve (E/A) Subgroup	
3	Life RBC WG	1	2022 or later	Provide recommendations for the appropriate treatment of longevity risk transfers by the new longevity factors.	New Jersey	Being addressed by the Longevity (E/A) Subgroup	
Carry-Over Items Currently being Addressed – Life RBC							
4	Life RBC WG	1	2022 or later	Update the current C-3 Phase I or C-3 Phase II methodology to include indexed annuities with consideration of contingent deferred annuities as well	AAA		
5	Life RBC WG	1	2022 or later	Work with the Life Actuarial (A) Task Force and Conning to develop the economic scenario generator for implementation.			
6	Life RBC WG	+	2021	Develop guidance for regulators as it relates to the potential impact of the bond-factor changes on 2021 RBC results and the trend test			
7	Life RBC WG	1	2022 or later	Review companies at action levels, including previous years, to determine what drivers of the events are and consider whether changes to the RBC statistics are warranted.			

Custody Control Accounts

March 2022

Credit mitigation vs. capital relief

- ▶ Life reinsurance transactions with licensed or accredited reinsurers generally do not require a collateral mechanism to provide credit for reinsurance (CFR).
- ▶ Separate and distinct from CFR, the Life RBC Manual instructions reference certain collateral mechanisms (e.g., funds withheld or trusteed collateral), which, if present, allow the Cedant to avoid an overstatement of RBC charges that would otherwise be applied for credit exposure to reinsurance counterparties. The Life RBC formula addresses uncollateralized credit exposure to reinsurers, whether admitted/accredited or unauthorized, and offers RBC credit only for certain listed collateral mechanisms.
- ▶ While the subject provision of the Life RBC Manual allows an RBC credit for certain non-CFR collateral mechanisms, certain other credit risk mitigation (comfort) arrangements developed by large custodial institutions are not similarly treated, resulting in significant inefficiencies in certain life reinsurance transactions.

Growing demand for 'comfort trusts'

- ▶ In many life reinsurance transactions, where the parties negotiate and agree to collateral arrangements for commercial reasons, they are forced to use trustee assets in order to achieve the desired RBC credit, even where a trust is not needed to satisfy CFR requirements; such "comfort trusts" are common in a variety of life reinsurance transactions, including block acquisitions, embedded value and reserve financings and pension risk transfers
 - J.P. Morgan is aware of numerous transactions that involve over \$50 billion of assets held in Comfort Trusts
- ▶ Other collateral mechanisms can provide the same level of security to Cedants with lower costs and greater flexibility.

Custody Control Accounts

- ▶ The Finance industry widely supports and leverages custodial control accounts (“Custody Control Accounts”) where segregated collateralization under third-party control is required (e.g. pledges to FHLBs, Segregated Initial Margin, variation margin for 40 Act clients, etc.).
 - In the same way, a Custodian can hold assets pledged by the Reinsurer for the benefit of the Cedant in connection with a reinsurance transaction.

- ▶ The intent of the Custody Control Account is to provide the same protections to the Cedant as would be provided by a trust arrangement. Both Comfort Trusts and Custody Control Accounts can be structured to:
 - Segregate assets to cover claims and other amounts payable under the subject reinsurance agreement
 - Establish a senior claim of the Cedant over the account assets in the event of a Reinsurer insolvency or receivership
 - Permit the Cedant to take control of the assets in the event of specified breaches of the reinsurance agreement
 - Allow the Cedant to monitor the composition of assets in the account
 - Restrict Reinsurer withdrawal and replacement of assets from the account based on agreed conditions

- ▶ However, a Custody Control Account offers the same operational control as a trust arrangement, at a reduced cost due to increased scale and automation:
 - Custodial arrangements represent the majority of collateralized assets held by Custodian banks.
 - Custody Control Accounts provide a greater level of automation and straight-through-processing, resulting in lower costs (up to \$100K per annum, per account) for all parties (insurers and Custodians).
 - Custody Control Accounts and Comfort Trusts both offer the following services: :
 - Priced Position Reporting
 - Monitoring of specific withdrawal and replacement conditions based on objective criteria
 - Detailed transaction reporting
 - Administration and servicing of assets
 - Today, Clients have a limited number of banks that are able to provide Comfort Trusts with the same capabilities and at the same price as a custody arrangement. By allowing Custody Control Accounts to receive the same RBC treatment as Comfort Trusts, insurers would be able to select among a larger group of providers.

Proposed changes to RBC instruction

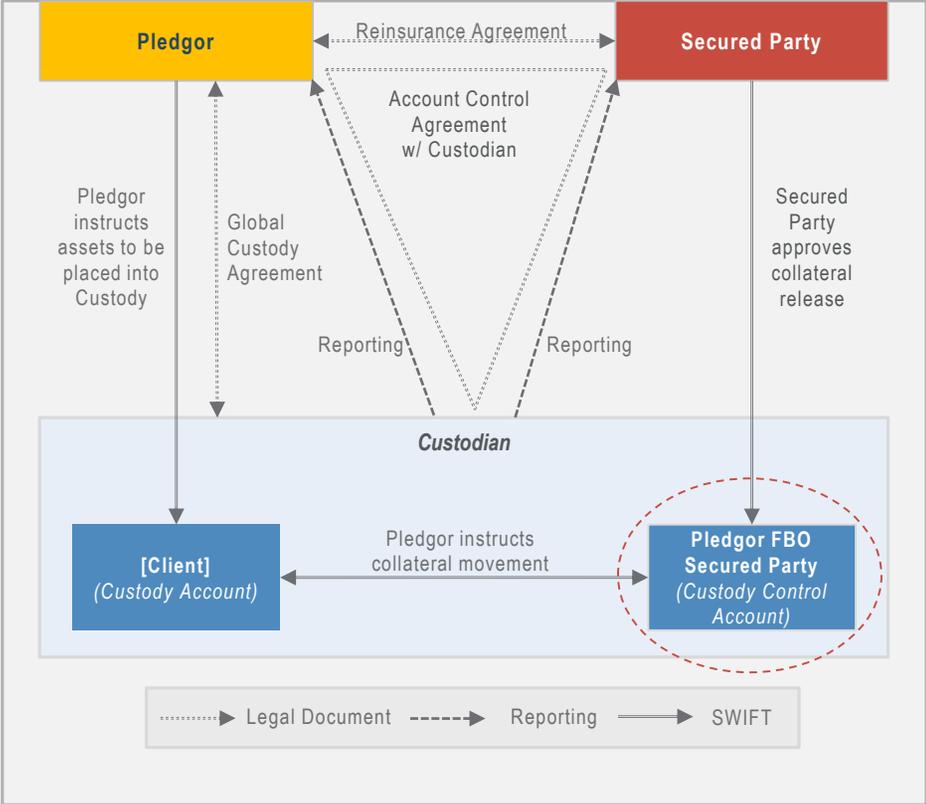
From Risk-Based Capital Forecasting & Instructions – Life and Fraternal, 2019

REINSURANCE

LR016 (p. 53 of the 2019 Edition)

There is a risk associated with recoverability of amounts from reinsurers. The risk is deemed comparable to that represented by bonds between risk classes 1 and 2 and is assigned a pre-tax factor of 0.78 percent. To avoid an overstatement of risk-based capital, the formula gives a 0.78 percent pre-tax credit for reinsurance with non-authorized and certified companies, for reinsurance among affiliated companies, for reinsurance with funds withheld or reinsurance with authorized reinsurers that is supported by equivalent trusted **or custodied** collateral ~~that meets the requirements of the types~~ stipulated in **paragraph 18 of** Appendix A-785 (Credit for Reinsurance), where there have been regular bona fide withdrawals from such trusted **or custodied** collateral to pay claims or recover payments of claims during the calendar year covered by the RBC report, and for reinsurance involving policy loans. Withdrawals from trusted **or custodied** collateral that are less than the amounts due the ceding company shall be deemed to not be bona fide withdrawals. **For purposes of these instructions, “custodied collateral” shall mean assets held pursuant to a custodial arrangement with a qualified U.S. financial institution (as defined in Appendix A-785 (Credit for Reinsurance)) pursuant to which the underlying assets are segregated from other assets of the reinsurer and are subject to the exclusive control of, and available to, the ceding company in the event of the reinsurer’s failure to pay under, and otherwise pursuant to the terms of, the subject reinsurance agreement.**

Custody Control Account



Legal & Operational Highlights

<p>Legal Documents Required</p>	<ul style="list-style-type: none"> ▶ Global Custody Agreement: Bilateral agreement for custodial services between Pledgor and Custodian ▶ Account Control Agreement: Tri-party agreement between Pledgor, Secured Party and Custodian
<p>Legal & Operational Framework</p>	<ul style="list-style-type: none"> ▶ Custody Bank acts as Custodian (<u>not</u> as Trustee) ▶ Custodian has subordinated lien over assets in the control account (though may retain a first priority lien for fees and expenses) ▶ Assets are segregated in a control account in the Pledgor's name FBO the Secured Party ▶ The Secured Party can assume control of the account at any time upon the satisfaction of conditions as stipulated in the underlying bilateral agreement w/ the Pledgor (e.g. an event of default as notified and exclusively determined by the Secured Party) and following Custodian's receipt of a Notice of Exclusive Control (NOEC). Custodian has a reasonable time to act on the instruction and does not validate the event of default. ▶ Custodian is indemnified for following instructions ▶ Custodian acts upon instructions by Pledgor to deliver assets into the control account ▶ Parties have flexibility to decide on the control model – i.e., whether release and/or substitution of assets requires single party or dual (Pledgor and Secured Party) instructions ▶ The Account Control Agreement supplements a Global Custody Agreement and is not a standalone agreement.

Key Features

<p>Custody</p>	<ul style="list-style-type: none"> ▶ Pledgor instructs assets to be placed into custody account free of payment ▶ Asset servicing on securities that are registered in J.P. Morgan's nominee name ▶ Automated income transfer capability, back to main custody account in respect of any income earned on depository eligible assets can be provided
<p>Control</p>	<ul style="list-style-type: none"> ▶ SWIFT message release automation for collateral release AND substitutions. Support for different arrangements (e.g. Single/Joint Authentication). ▶ Secured Party can assume control of account upon Notice of Exclusive Control instruction to the Custodian (NOEC)
<p>Reporting</p>	<ul style="list-style-type: none"> ▶ Consolidated custody reporting available to both client and secured party ▶ View and schedule customized or pre-defined reports ▶ Intra-day and end-of-day reporting via SWIFT

The chart below summarizes key comparisons between: (1) a trust account established by a reinsurer to provide an asset or reduction from liability to a ceding company for reinsurance ceded (a “Credit for Reinsurance Trust”); (2) a trust account established by a reinsurer in connection with a reinsurance agreement that is not necessary to provide an asset or reduction from liability for reinsurance but rather provides credit protections to the ceding company (a “Comfort Trust”); and (3) a custodial account established by a reinsurer to provide credit protections to a ceding company in connection with a reinsurance agreement (a “Comfort Custodial Account”). With respect to a Comfort Custodial Account, the chart contemplates the structure proposed by JPMorgan in connection with its proposed changes to the RBC Manual.

	Credit for Reinsurance Trust	Comfort Trust	Comfort Custodial Account
Nature of Reinsurer	Reinsurer is not licensed or accredited in Cedant’s domiciliary jurisdiction.	Reinsurer is licensed or accredited in the Cedant’s domiciliary jurisdiction.	Reinsurer is licensed or accredited in the Cedant’s domiciliary jurisdiction.
Effect on Credit for Reinsurance	Collateral in trust provides a reduction for liability (statutory credit for reinsurance) where Reinsurer is not licensed or accredited.	No effect on Credit for Reinsurance as collateral is not required in order for the Cedant to receive statutory reserve credit.	No effect on Credit for Reinsurance as collateral is not required in order for the Cedant to receive statutory reserve credit.
Cedant Reinsurance Counterparty Credit Exposure RBC Charges and Credits	An RBC credit is applied to offset the RBC charge for reinsurance counterparty credit exposure because such exposure has been mitigated through the trust mechanism.	An RBC credit is applied to offset the RBC charge for reinsurance counterparty credit exposure because such exposure has been mitigated through the trust mechanism.	Although credit exposure would be reduced under a Comfort Custodial Account similar to both a Credit for Reinsurance Trust or Comfort Trust, the current RBC instructions mandate a reinsurance counterparty credit charge with no offsetting credit because of the form of the legal agreement governing the collateralization arrangement. Under JPMorgan’s proposed revisions to the RBC Instructions, the RBC charges and credits across all three of these arrangements would be harmonized. Custodial Account Equivalent with a trust.

	Credit for Reinsurance Trust	Comfort Trust	Comfort Custodial Account
Structure	Assets deposited in trust with a third-party trustee by the Reinsurer for the benefit of the Cedant.	Assets deposited in trust with a third-party trustee by the Reinsurer for the benefit of the Cedant.	Assets deposited in custodial account established by the Reinsurer with a third-party account bank subject to the first priority lien and exclusive control of the Cedant.
Asset Classes	Assets permitted to be deposited in trust are specified by the applicable statute. Frequently limited to cash, U.S. Treasuries or Agencies and SVO Listed Securities.	Asset classes are subject to the RBC instructions, and additionally include foreign securities, equity interests and interests in investment companies.	Asset classes would be subject to the RBC instructions, and additionally include foreign securities, equity interests and interests in investment companies.
Valuation	Cedant is only allowed to receive credit for reinsurance based on the <u>market value</u> of assets of the Trust Account.	Valuation is based on the contractual agreement between the parties. Frequently comfort trust agreements and related reinsurance agreements provide that the asset balance required is based on <u>book value</u> of assets unless one or more specified credit events have occurred, in which case market values are required.	Similar to a Comfort Trust, parties would agree to method of valuation of account assets.
Duties of Trustee/Bank	Trustee is a directed trustee, required to hold assets and act in accordance with the instructions of the parties, as set forth in the Trust Agreement.	Trustee is a directed trustee, required to hold assets and act in accordance with the instructions of the parties, as set forth in the Trust Agreement.	Bank would be required to hold assets and act in accordance with the instructions of the parties, as set forth in the Account Control Agreement.
Title of Assets	Title of assets is transferred to the trustee of the trust.	Title of assets is transferred to the trustee of the trust.	Title of assets is maintained by the Reinsurer, but subject to a lien in favor of the Ceding Company, which lien is perfected through exclusive control over the assets pursuant to an Account Control Agreement.

	Credit for Reinsurance Trust	Comfort Trust	Comfort Custodial Account
Withdrawal Conditions	<p>No conditions are allowed for the withdrawal of assets by the Ceding Company.</p> <p>Withdrawal of assets by the Reinsurer is generally not allowed except to the extent that the market value of assets exceeds 102% of the reserves ceded under the reinsurance agreement, in which case the Reinsurer can request the trustee to release such excess.</p>	<p>Reason and nature for withdrawal by the Ceding Company are agreed to by the parties and is typically based on specified defaults of the Reinsurer.</p> <p>Withdrawals by Reinsurer may be allowed based on both market value or book value tests; if such tests are met, the Reinsurer can request the trustee to release such excess.</p>	<p>Reason and nature for withdrawal by the Ceding Company are agreed to by the parties and is typically be based on specified defaults of the Reinsurer.</p> <p>Withdrawals by Reinsurer may be allowed based on both market value or book value tests; if such tests are met, the Reinsurer can request the Bank to release such excess and the corresponding lien.</p>
Substitution of Assets	<p>Substitution of assets are only allowed to the extent that the market value of replacement assets exceeds the market value of the replaced assets.</p>	<p>Restrictions on substitutions are agreed between the parties and are typically based on book value and market value of relevant assets.</p>	<p>Restrictions on substitutions are agreed between the parties and are typically based on book value and market value of relevant assets.</p>

January 24, 2022

Capital Adequacy (E) Task Force

RBC Proposal Form

- | | | |
|---|---|--|
| <input type="checkbox"/> Capital Adequacy (E) Task Force | <input type="checkbox"/> Health RBC (E) Working Group | <input type="checkbox"/> Life RBC (E) Working Group |
| <input type="checkbox"/> Catastrophe Risk (E) Subgroup | <input type="checkbox"/> Investment RBC (E) Working Group | <input type="checkbox"/> Operational Risk (E) Subgroup |
| <input type="checkbox"/> C3 Phase II/ AG43 (E/A) Subgroup | <input type="checkbox"/> P/C RBC (E) Working Group | <input type="checkbox"/> Longevity Risk (A/E) Subgroup |

<p style="text-align: right;">DATE: _____</p> <p>CONTACT PERSON: _____</p> <p>TELEPHONE: _____</p> <p>EMAIL ADDRESS: _____</p> <p>ON BEHALF OF: _____</p> <p>NAME: _____</p> <p>TITLE: _____</p> <p>AFFILIATION: _____</p> <p>ADDRESS: _____</p>	<p style="text-align: center;"><u>FOR NAIC USE ONLY</u></p> <p>Agenda Item # _____</p> <p>Year _____</p> <p style="text-align: center;"><u>DISPOSITION</u></p> <p><input type="checkbox"/> ADOPTED _____</p> <p><input type="checkbox"/> REJECTED _____</p> <p><input type="checkbox"/> DEFERRED TO _____</p> <p><input type="checkbox"/> REFERRED TO OTHER NAIC GROUP _____</p> <p><input type="checkbox"/> EXPOSED _____</p> <p><input type="checkbox"/> OTHER (SPECIFY) _____</p>
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IDENTIFICATION OF SOURCE AND FORM(S)/INSTRUCTIONS TO BE CHANGED

- | | | |
|--|---|--|
| <input type="checkbox"/> Health RBC Blanks | <input type="checkbox"/> Property/Casualty RBC Blanks | <input type="checkbox"/> Life and Fraternal RBC Instructions |
| <input type="checkbox"/> Health RBC Instructions | <input type="checkbox"/> Property/Casualty RBC Instructions | <input type="checkbox"/> Life and Fraternal RBC Blanks |
| <input type="checkbox"/> OTHER _____ | | |

DESCRIPTION OF CHANGE(S)

In reference to SAPWG referral 2020-#36 (8/13/2018) and VOSTF referral 2020-#38 (9/21/2018); Attribute bond risk-based capital (RBC) factors to bond mutual funds that have applied for Regulatory Treatment Analysis Service (RTAS) and have received a National Association of Insurance Commissioners (NAIC) designation from the Securities Valuation Office (SVO), based on a look-through calculation of the credit risk for the fund's underlying bonds, using a weighted average rating factor methodology (WARF) in conjunction with a qualitative review of the fund's pertinent U.S. Securities and Exchange Commission (SEC) registered investment documents. Proposed factor changes:

Current (SVO review unavailable)		New (With SVO review)			
Designation	Factor	Designation	Life Factors	P&C Factors	Health Factors
NA	0.300	1.A	0.00158	0.002	0.003
		1.B	0.00271	0.004	0.005
		1.C	0.00419	0.006	0.008
		1.D	0.00523	0.008	0.011
		1.E	0.00657	0.010	0.014
		1.F	0.00816	0.013	0.016
		1.G	0.01016	0.015	0.019
		2.A	0.01261	0.018	0.022
		2.B	0.01523	0.021	0.025
		2.C	0.02168	0.025	0.031
		3.A	0.03151	0.055	0.069
		3.B	0.04537	0.060	0.076
		3.C	0.06017	0.066	0.083
		4.A	0.07386	0.071	0.089
		4.B	0.09535	0.077	0.097
		4.C	0.12428	0.087	0.110
		5.A	0.16942	0.098	0.123
		5.B	0.23798	0.109	0.137
		5.C	0.30000	0.120	0.151
		6	0.30000	0.300	0.300

REASON OR JUSTIFICATION FOR CHANGE **
Background

Until recently, all mutual funds, bond or equity-oriented, were classified as “common stock,” unless they met specific eligibility criteria for inclusion on the now-discontinued Money Market Mutual Fund List or Bond Mutual Fund List. The Bond Mutual Fund List eligibility criteria were narrow in scope¹, only permitting bond-like treatment of a mutual fund if it invested solely in Purposes and Procedures (P&P) Manual-listed U.S. Government securities with the fund maintaining the highest credit quality rating given by an NAIC Credit Rating Provider (CRP). Since the discontinuation of these lists, the SVO has positioned a new list known as the NAIC Fixed Income-Like SEC Registered Funds List to allow for the evaluation and inclusion of mutual funds that predominantly invest in individual bond securities.

NAIC staff previously questioned the equity-like treatment for bond mutual funds as part of the Statutory Accounting Principles (E) Working Group’s (SAPWG) investment classification project. As a part of this project, NAIC staff determined that the inclusion of “mutual funds” within the “common stock” definition was overly broad.² Consequently, the SAPWG adopted a proposal to add a column on Schedule D, Part 2, Section 2 (subsequently implemented by Blanks (E) Working Group) that would permit funds designated by the SVO (and only funds designated by the SVO) to be reported on that schedule. Eligibility for such reporting would require an NAIC designation that could, in turn, align with an RBC factor to be determined by the Capital Adequacy (E) Task Force. This action effectively recognized that with appropriate review of underlying holdings, more appropriate risk-based capital treatment can be achieved through the designation process, without changing the reporting schedule or accounting for such investments. This adoption led to a referral from SAPWG (2020–#36) for RBC consideration.

Concurrently, the Valuation of Securities (E) Task Force (VOSTF) directed NAIC staff to develop a comprehensive proposal to ensure consistent treatment for investments in funds that predominantly hold bond portfolios, across all schedules. Significant efforts were made to align fund guidance and evaluation treatment in the P&P Manual. The adopted language created the new, aforementioned NAIC Fixed Income-Like SEC Registered Funds List of the P&P Manual, which expanded the existing evaluation framework to permit review and designation for all funds issued by an investment company whose offering is registered with and regulated by the SEC and whose published investment objective is to invest almost exclusively in bonds. The VOSTF’s procedure permits the sponsor of a fund or an insurer to request an SVO assessment of a fund to determine if it meets requirements imposed by the Task Force for more appropriate treatment. If the fund is eligible, the SVO adds the name of the fund to the relevant list with a preliminary NAIC designation. This adoption led to a referral from VOSTF (2020–#38) that the Capital Adequacy (E) Task Force (CAPAD) consider formally integrating the comprehensive instructions for mutual funds adopted for the P&P Manual into the NAIC RBC framework, by attributing bond RBC factors to any bond fund meeting the P&P Manual criteria, and achieving an NAIC designation through the SVO’s evaluation process.

Both of these preceding events and changes have effectively positioned bond mutual funds to be accurately evaluated, designated, and reported with RBC charges that are reflective of the bond securities within the fund.

Regulation

Bond mutual funds (investment companies) are registered with and regulated by the SEC and have published investment objectives to invest in bonds. Strict regulation has enabled bond mutual funds to reliably deliver bond exposure to investors for over 85 years, through unprecedented market events, such as the interest rate shock in the 1970s that saw the U.S. Federal Funds’ rate go above 14%, and also, when interest rates were cut to near 0%, during the global financial crisis and the years that followed. As of year-end 2020, there is over \$5.2 trillion in total net assets entrusted to the bond mutual fund investment structure (ICI Investment Company Fact Book 2021).

¹Purposes and Procedures Manual of the NAIC Investment Analysis Office: Part Three – SVO Procedures and Methodology for Production of NAIC Designation (2019); “A bond mutual fund is eligible for inclusion on the Bond List if the fund meets the following conditions: The fund shall invest 100% of its total assets in the U.S. Government securities listed in the section below, class 1 bonds that are issued or guaranteed as to payment of principal and interest by agencies and instrumentalities of the U.S. Government, including loan-backed bonds and collateralized mortgage obligations, and collateralized repurchase agreements comprised of those obligations at all times.”

²SAPWG – Ref #2013-36 – SSAP No. 30 – Common Stock – Key Elements: The inclusion of “mutual funds” within the “common stock” definition is overly broad and allows inclusion of all “investment company” investments, and the characteristics of some of these investments may warrant separate accounting and reporting consideration (e.g., look-through). Per the SEC, an “investment company” is a company (corporation, business trust, partnership, or limited liability company) that issues securities and is primarily engaged in the business of investing in securities.

Mutual funds are stringently regulated under the Investment Company Act of 1940 (the “’40 Act”) and the Securities Act of 1933. These laws impose extensive obligations on the mutual fund and its investment adviser. As an SEC-regulated investment company, a mutual fund must invest its portfolio assets in accordance with the investment strategies outlined in its prospectus and other governing fund documents. The fund prospectus is an SEC-regulated legal document, updated annually, to inform current and prospective investors of the risks, fees, and investment strategy of the fund. It is not permissible for a bond mutual fund to change its investment strategy in any fundamental way that does not require the fund to at least notify its shareholders of the change, and in most cases, a mutual fund’s fundamental investment strategies cannot be altered without shareholder approval.

Additionally, Section 17(f) of the ’40 Act imposes strict regulations that require the portfolio securities (purchased on behalf of the investors) to be held by an independent custodian, segregated from the fund sponsor’s own assets. Section 17(f) also requires the net assets of the fund to be physically segregated from assets of other funds, and from the assets of the investment adviser (or any other person/entity), and provides for, among other things, periodic examinations of the assets by an independent public accountant. Finally, the SEC requires mutual fund custodians to protect a fund’s assets by segregating them from their own assets. Fund custodians must have authorized instructions from the fund’s authorized representative, designated by an officer of the fund, to deliver securities or cash from the fund.

Structure

Mutual funds should be treated (for RBC purposes) in accordance with their underlying portfolio holdings because those portfolio securities drive the value and risks of the mutual fund. A shareholder in a mutual fund has a proportionate interest in, and exposure to, the underlying portfolio of securities held by the mutual fund. Bond mutual funds exist to pool the interests of many shareholders for the purpose of investing in fixed-income securities and pass through the cash flows and investment returns generated by its bond portfolio. Because the mutual fund must honor investor redemption requests at the Net Asset Value (NAV) per share, that is, at the actual value of the investor’s proportionate interest in the mutual fund’s underlying bond portfolio, the NAV is a highly accurate reflection of the fund’s underlying portfolio. The fund is simply a conduit for the performance of the underlying portfolio securities, as the federal securities laws make clear – under Rule 22c-1 of the ’40 Act, shares of an open-end mutual fund generally may only be bought or sold at the fund’s net asset value, which is the value of its underlying portfolio securities less fund liabilities and expenses as determined under Rule 2a-4 of the ’40 Act. Consequently, the risks of investing in a mutual fund are a reflection of the securities constituting its portfolio. In the case of a bond mutual fund, the risks and interests represented are that of the individual bonds held.

An examination of what this structure means for insurers

A bond mutual fund is not an operating company engaged in a trade or business that issues common stock and does not share inherent characteristics of common stock.¹ The securities that the bond mutual fund holds represent the economic value of the fund. In other words, a bond fund investor has no rights in the underlying securities owned, with respect to: 1) ownership of the companies; 2) voting rights in those companies, and; 3) sharing in the company profits or losses. Any contention that a bond mutual fund should be treated as an equity from a RBC standpoint is inconsistent with these rights and the debt exposures conveyed through the ’40 Act structure.

As previously stated, a bond mutual fund shareholder has a proportionate interest in the underlying securities (bonds), as reflected in the current NAV per share for the fund, but only directly owns shares of the mutual fund. The shareholder does not directly own the bonds, and therefore, does not have a direct creditor relationship with the issuer.² Instead, the bond mutual fund, as a registered investment company, is the direct owner of the individual bonds, and carries the creditor relationship with the issuers. Within this legal structure, the fund itself (as creditor) does not default, in the traditional sense, with respect to its relationship with the shareholder. Rather, each individually owned bond within the portfolio carries risk of default to its creditor (i.e., the bond mutual fund). For this structural reason, default risks occur “within the fund” at the same statistical occurrence rate as in any other debtor/creditor ownership structure for the bond securities (e.g., an insurer owning the bond directly). Any default occurrence is immediately recognized in the fund’s NAV, just as any other institutional investor would recognize the same default on their balance sheet. Therefore, credit risk of a bond mutual fund can be represented as a product of the weighted average credit risk of the individual bonds owned by the fund, and probabilities of default hold true for each underlying security. As with direct bond ownership, bond funds have interest rate, inflation, and credit risk associated with the underlying bonds owned by the fund, reflected in the daily NAV.

¹Section 3(a)(1)(C) of the [Investment Company Act](#) defines an investment company as an issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire “investment securities”

²Management companies usually are structured as corporations or trusts. A management company’s board of directors (or trustees) oversees the management of the company. See [Section 2\(a\)\(12\) of the Investment Company Act](#). A management company’s investment adviser (which is typically a separate entity, registered with the Commission) manages the company’s portfolio securities for a fee. See [Section 2\(a\)\(20\) of the Investment Company Act](#).

We can further examine this structure by defining the prospective constituents. Within the bond mutual fund legal structure, the fund is the investment “company”¹, and the registered investment adviser of the fund serves as the portfolio manager, investing for economic benefit for the “company”.² This economic benefit is then proportionally passed-through the registered investment company (i.e., mutual fund) to the shareholder (e.g., insurer), in exchange for a fee, in the form of an expense ratio. Similarly, an insurance “company” may directly own a portfolio of hundreds or thousands of bonds that are managed by an internal team of investment management professionals that it compensates for these services, for the economic benefit of their general account and policy holders. Finally, an insurance “company” may access these bonds through a separately managed account (SMA) of individual bonds, managed on behalf of the “company” by a professional asset management firm. Once again, the investment adviser is acting in a fiduciary capacity for the insurer for the economic benefit of the “company” and its owners, in exchange for a management fee.

Structure	Portfolio holdings	Bond Owner	Portfolio Adviser	Economic Benefit
Mutual Fund	100 Bonds	Mutual Fund	Fund Sponsor	Insurer General Account
Separately Managed Account	100 Bonds	Insurer	Investment Firm	Insurer General Account
Direct ownership	100 Bonds	Insurer	Insurer Employee	Insurer General Account

In all three arrangements, regardless of structure, there is a portfolio of bonds, a company that owns those bonds, portfolio adviser, and economic benefit passed on to the general account. Bonds held directly, or through other types of investment vehicles, hold the same types of securities. Therefore, portfolios of securities held in registered open-end management investment companies under the '40 Act should receive similar RBC treatment, in order to promote consistent, accurate application of capital treatment for structural ownership arrangements that produce the same economic value and risks.

An examination of credit rating downgrades

Based on structure, it should also be noted that there are no significant differences with respect to individual bond downgrades and the options available to manage such downgrades. This includes passively managed mutual funds that track a fixed income benchmark. When an issuer downgrade occurs, the downgrade is uniformly occurring within the bond market for any creditor, whereby a negative change in the rating of the bond security has occurred. A downgrade happens when a credit rating agency analyst feels that the future prospect for the security has weakened from the original recommendation, usually due to a material and fundamental change in the company's operations, future outlook, or industry, but does not indicate a guarantee of default. In each structure described, the owner has similar options.

While a passively managed mutual fund's objective is to track and deliver indexed returns, it is not legally obligated to sell a bond that has been downgraded out of scope of the index, at the time of the announced downgrade event, or even at the time in which the tracked benchmark provider removes the bond from the index, on the last day of the month of occurrence. Instead, the mutual fund, just like the individual institutional owner or SMA, has options to mitigate its risk and manage its portfolio for the benefit of the shareholder. In all ownership structures, the owner may: 1) sell the bond; or 2) hold the bond despite the implied increase of risk.

Also, a downgrade does not necessarily equate to illiquidity and can result in either a discounted sale price option for the owner (immediately recognized in the NAV of a mutual fund), or in some instances, an increased value and sale price (recognized increase to mutual fund NAV) in the bond market, due to the market's perception of a higher yield from the issuer that may not necessarily represent increased default risks to the prospective buyer. A mutual fund provider may leverage its scale and strong broker/dealer relationships to trade this security at a specific time (or over time) that will give the fund best execution and economic value.

Additionally, downgrades occur annually for a relatively small portion of the total U.S. bond market, and have represented less than 1% of issuance, on average, from 2007 to 2020.* Of these downgrades, the majority remained within investment grade quality, with only 0.1% falling below investment grade.* At the same time, a bond mutual fund only holds a fraction of bond market issues, and therefore may only own a fraction of a fraction of downgraded bonds that could in any manner impact a decision to sell the bond from the portfolio. As was previously discussed, these decisions to potentially mitigate portfolio risk are no different across ownership structures and immaterial in the decision to apply a certain set of risk-based capital factors.

*Calculated based on, Bloomberg Finance L.P., Moody's, S&P, Fitch, and SIFMA market data.

Validity of evaluation methodology

The recommendation to apply bond factors to bond mutual funds, based on an SVO quantitative and qualitative review, is based on an NAIC approach successfully conducted for almost 30 years (see previous citation of eligible bond mutual funds that invest 100% of their total assets in the U.S. Government securities). The approach is consistent with past NAIC practice, easy to implement, and considers the role of the VOSTF in identifying investment risks and the practical approach expressed in the administration of the RBC framework, which is based on default characteristics of corporate bonds, but applied to many other instruments, with risk and default characteristics unlike those of corporate bonds. This method for evaluating risk, and application of bond factors as a proxy to achieve appropriate levels of risk-based capital for these investments, has proven over decades that it is built on sound policy and should also be readily be applied to bond mutual funds.

Current SVO procedures permit the sponsor of a fund, or an insurer, to request a SVO assessment of a fund to determine if the fund is within scope of the comprehensive instructions for mutual funds, adopted in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual). If, and only if, the fund is eligible, the SVO conducts an analysis, and adds the name of the fund to the relevant list, with a preliminary NAIC designation. Therefore, any bond mutual funds not submitted through the established SVO framework would continue to be covered by SSAP No. 30 and remain ineligible for NAIC designation and/or corresponding bond RBC factors. This rigorous process includes evaluation upon initial submission to the SVO and an ongoing process that has the ability to adapt ratings if a fund's composition or investment approach changes. For any rated fund the analysis would be conducted by the SVO twice each year; once during the fund provider's mandatory annual review and again when an insurer files notice of its ownership of the fund.

The SVO's well-developed analysis framework (successfully implemented for bond ETFs since 2004) includes a comprehensive look-through to all securities held in the investment in order to assess the inherent risks borne by the fund. This calculation of the credit risk for the fund's underlying investment portfolio uses a weighted average rating factor methodology (WARF). The WARF factor for each portfolio security (issue/security specific) is determined by first translating its NAIC CRP rating into an NAIC Designation. For bond securities that are unrated but have an NAIC Designation, the Designation is used. The WARF factor for that NAIC Designation is then market value-weighted. The weighted factor for each investment is summed to determine the fund's credit rating, which is then translated into the equivalent NAIC Designation.

The analysis is detailed in nature and accurately identifies similar risks of credit quality and interest rate sensitivity, associated with the underlying bonds, but also scrutinizes the rare instances where funds have more of a heterogeneous investment profile or dispersion of risk. The analysis is built on three key pillars:

- An extensive ***quantitative look-through*** analysis that is built on sound mathematical principles, in which a fund cannot "hide" lower-quality bonds behind those with stronger credit quality. Instead, the risks of any lower-quality bonds result in a higher NAIC designation and corresponding RBC charge. This total charge for a given dollar of investment is often higher than if the same dollar was invested with proportionate weighting in each individual bond within the portfolio. As an example, Vanguard's designated bond ETFs consistently give insurers diversified exposure to "higher" credit quality, relative to the applied NAIC designation, corresponding RBC factor, and total capital charge. (Data can be provided upon request. The same principle will hold true for similarly structured '40 Act mutual funds.).
- A ***qualitative review*** of the fund, considering the fund's objectives and investment constraints, as outlined in the SEC-regulated prospectus; thus, the SVO review considers the full range of the fund's possible future bond investments, not just the present.
- ***Ongoing regulatory oversight*** of the mutual funds used in insurers' portfolios, which remains a critical safeguard. If an insurance company buys a preliminarily designated listed fund, it must file that fund with the SVO for an additional analysis and official validation of the previously analyzed credit risks in order to receive an official NAIC designation. This new analysis takes into account any credit quality changes in a fund, including previously discussed downgrades, which may or may not have been sold from the fund. Only after this additional analysis does the SVO assign an official NAIC designation and enter the security into the NAIC systems for fixed-income like treatment.

Validity and summary of bond factor application

A mutual fund is a reflection of the composition of individual bonds within the fund's portfolio. Every bond mutual fund will have its own unique number and variety of holdings, credit quality exposure, and therefore risk associated with the fund. Due to the endless variety of holdings and credit exposure that a fund can contain, a single, one-time analysis cannot be conducted at a mutual fund industry level to standardize new RBC factors to be applied across various "buckets" of bond mutual funds. Therefore, the approach to look-through each submitted bond mutual fund, using the WARF methodology, and apply as a proxy a bond designation, is the only appropriate analysis that can be conducted to accurately apply an RBC factor aligned with the risk of each unique portfolio.

As previously described, mutual funds are pass-through entities that pass through the cash flows and investment experience generated by the portfolio. If the fund only holds debt, the investor will only experience debt-like cash flows through the fund, generated by the principal and interest of the individual bonds held by the fund. Additionally, the risks of the bond fund are a reflection of the aggregate risks of each underlying bond component of the portfolio. As an investor in those bonds, a mutual fund bears those risks proportionate to its exposure in the security in the same manner that an insurer would bear the risk proportionate to their investment exposure in a specific individual bond held.

Within the context of RBC and how bond factors are attributed on a basis of a debtor's ability to meet obligations to a creditor, the mutual fund "company" itself does not default in its relationship with the shareholder, because there is no creditor/debtor relationship with the shareholder. Therefore, standardized default rates of funds cannot be analyzed. Similarly, an insurer who owns a portfolio of bonds does not default, but rather, individual bonds within the insurer's portfolio have default probabilities based on the credit quality of the issuer and the risk to not meet obligations. The same economic experience exists for both investing entities, and each creditor has the same legal protections and opportunity for economic recovery. However, in the event a decision is made to trade the bond in default, a bond mutual fund provides a structural advantage to most other institutions, due to scale and broker/dealer relationships that include dedicated coverage. Because of these advantages, bond mutual funds can more effectively trade these bonds at an opportune time, thus creating efficiencies of value in comparison to other owners of the issuance in default.

As the owner of the individual bonds, the mutual fund has a direct creditor relationship with the bond issuer and is subject to default at a statistical rate inherent in the creditworthiness of the issuer. In this case, the mutual fund directly bears the risk of issuer default and the financial impact in a manner proportionate to each bond. This is the same creditor relationship and risk that an individual insurer experiences when it directly owns individual bonds with varying credit qualities, at varying amounts, within their individually managed portfolio or SMA. Therefore, RBC for the individual insurance company is an aggregate of the weighting the insurer has to each individual bond and its credit quality. Similarly, when the SVO analyzes a mutual fund they look at the individual weighting to each bond and its credit quality to produce a weighted average, just as you mathematically can with an individual insurer's portfolio. (Data can be provided upon request.)

Impact

Impact should be considered secondary to applying charges that are appropriate to the risk of the investment and the validity of such factors, as previously described. Utilization of bond RBC factors will be aligned with the CAPAD policy that insurers are capitalized at a minimally acceptable level and aligned and implemented through an SVO methodology that accurately assesses the underlying credit risk. With accurate application of valid RBC factors, impact will be appropriate.

Bond mutual funds offer a number of benefits to insurers, including the ability to redeem shares with the fund, daily valuation of the portfolio at NAV, immediate low-cost diversification, and professional investment management. By pooling together the assets of thousands or millions of investors, mutual funds achieve greater scale and efficiency than virtually any investor, including many insurers, could hope to obtain individually. Importantly, the biggest beneficiaries of a broader inclusion of bond mutual funds for bond RBC application would be small and mid-size insurers. In our experience, these companies often have challenges constructing diversified bond portfolios without incurring high costs because of the comparatively limited scale of their portfolios. Allowing for expansion of bond factor application to SVO evaluated bond mutual funds would accurately reflect the inherent risk in the portfolio and remove an inconsistent barrier to these low-cost options provided by top institutional money managers. These managers can help insurers increase the probability of meeting their portfolio goals while simultaneously reducing risk through greater diversification.

For those insurers that currently invest in bond mutual funds, but receive an equity-like factor, future impact to RBC cannot be accurately measured, because there is an unknown variable in the number of bond mutual fund asset managers that will apply for RTAS in order to receive an NAIC designation with a corresponding bond factor. However, given the knowledge and resources required to submit a mutual fund for such treatment, it can reasonably be hypothesized that a limited number of mutual funds will apply for the SVO review process and receive bond factors, leading to a minimal effect across these held bond mutual funds and on insurer RBC. Below, is a historical three-year summary of the small amount invested in bond mutual funds that would have asset manager "eligibility" to apply for review and bond factor treatment.

Approximate bond mutual fund admitted assets (\$MM)	2017	2018	2019	2020
Life companies	\$565	\$1,200	\$725	\$964
Non-life companies	\$3,735	\$3,100	\$4,275	\$4,836
Total	\$4,300	\$4,300	\$5,000	\$5,800

These invested funds would be eligible for bond factor RBC only if they submit for, and undergo, the SVO evaluation process, leading to an official NAIC designation listing. The above figures equate to less than 1/10 of 1% of insurers' net admitted assets, according to statutory filings. Given the incredibly small allocation to bond funds within insurer portfolios, even in the most extreme assumed instance, where RBC would reduce from a 30% common stock charge to the lowest NAIC designation and charge (0.39% or 0.30%) for all current holdings, there would be very little impact to investment RBC, which is only one contributing factor to a company's overall RBC.

Administrative Changes

@ NAIC RBC Group

Additional Staff Comments:

**** This section must be completed on all forms.**

Revised 2-2019