NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Date: 7/5/22

Virtual Meeting

FINANCIAL CONDITION (E) COMMITTEE
Thursday, July 21, 2022
3:00 – 4:00 p.m. ET / 2:00 – 3:00 p.m. CT / 1:00 – 2:00 p.m. MT / 12:00 – 1:00 p.m. PT

ROLL CALL

Scott A. White, Chair	Virginia	Chlora Lindley-Myers	Missouri
Elizabeth Kelleher Dwyer, Vice Chair	Rhode Island	Marlene Caride	New Jersey
Michael Conway	Colorado	Adrienne A. Harris	New York
David Altmaier	Florida	Michael Wise	South Carolina
Doug Ommen	Iowa	Cassie Brown	Texas
Timothy N. Schott	Maine	Nathan Houdek	Wisconsin
Grace Arnold	Minnesota	Jeff Rude	Wyoming
Mike Chaney	Mississippi		

NAIC Support Staff: Dan Daveline/Julie Gann/Bruce Jenson

AGENDA

1. Welcome and Overview of Agenda—*Commissioner Scott A. White (VA)*

2. Consider Adoption of a Request for NAIC Model Law Development —*Commissioner James J. Donelon (LA)* — Attachment A

3. Consider Adoption of Regulatory Considerations Applicable to (But Not Exclusive to) Private Equity (PE) Insurers —Commissioner *Marlene Caride (NJ)* — Attachment B

4. Consider Adoption of the List of Jurisdictions that Recognize and Accept the Group Capital Calculation (GCC)—*Robert Wake (ME)* — Attachment C

5. Discuss Related Party Consideration Disclosures—*Dale Bruggeman (OH)* — Attachment D

6. Receive an Update on the Bond Proposal Project—*Dale Bruggeman (OH) / Kevin Clark (IA)* — Attachment E

7. Discuss Any Other Matters Brought Before the Committee —*Commissioner Scott A. White (VA)*

8. Adjournment

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Adopted by the Receivership and Insolvency (E) Task Force, 06/02/22

REQUEST FOR NAIC MODEL LAW DEVELOPMENT

This form is intended to gather information to support the development of a new model law or amendment to an existing model law. Prior to development of a new or amended model law, approval of the respective Parent Committee and the NAIC's Executive Committee is required. The NAIC's Executive Committee will consider whether the request fits the criteria for model law development. Please complete all questions and provide as much detail as necessary to help in this determination.

Please check whether this is: ☐ **New Model Law** **or** ☒ **Amendment to Existing Model**

1. Name of group to be responsible for drafting the model:

Receivership Law (E) Working Group of the Receivership and Insolvency (E) Task Force to complete the drafting. Referred by the Restructuring Mechanisms (E) Working Group.

2. NAIC staff support contact information:

Jane Koenigsman
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Dan Daveline
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816-783-8134

3. Please provide a brief description of the proposed new model or the amendment(s) to the existing model. If you are proposing a new model, please also provide a proposed title. If an existing model law, please provide the title, attach a current version to this form and reference the section(s) proposed to be amended.

- ***Property and Casualty Insurance Guaranty Association Model Act (#540)***

In 2019, the Financial Condition (E) Committee formed the Restructuring Mechanisms (E) Working Group who was charged with the following:

1. Evaluate and prepare a white paper that:
    a. Addresses the perceived need for restructuring statutes and the issues those statutes are designed to remedy. Also, consider alternatives that insurers are currently employing to achieve similar results.
    b. Summarizes the existing state restructuring statutes.
    c. Addresses the legal issues posed by an order of a court (or approval by an insurance department) in one state affecting the policyholders of other states.
    d. Considers the impact that a restructuring might have on guaranty associations and policyholders that had guaranty fund protection prior to the restructuring.
    e. Identifies and addresses the legal issues associated with restructuring using a protected cell.

Background for Proposed Change
This proposed change is being precipitated by discussions within the NAICs Restructuring Mechanisms (E) Working Group initiative, which is focused on documenting in the form of a White Paper, the various issues related to insurance business transfers (IBT) and corporate division (CD) transactions. The number of states adopting laws that permit either of these transactions is still relatively low; however, one of the most significant issues that has been discussed during the meetings of the Working Group is the need for policyholders subject to such transactions to retain guaranty fund coverage. Representatives of the National Conference of Insurance Guaranty Funds (NCIGF) have suggested that an amendment to a state's guaranty fund act, or other related law, is necessary to address this issue. They have specifically suggested that the NAIC update the Property and Casualty Insurance Guaranty Association Model Act, and they have developed specific language to address this issue. An amendment will better enable those states that have incorporated #540 into their laws to update their laws for this important issue, to ensure policyholders in all states retain their coverage. Because guaranty association coverage follows the state of licensure rather than the state of

domicile, adequately addressing these concerns is necessary regardless of the type of transfer and regardless of how few states adopt changes to their laws to allow IBT and CD transactions.

Scope of the Proposed Revisions to Model 540
The scope of the request is limited to addressing the issue of continuity of guaranty fund coverage when a policy is transferred from one insurer to another. The request is therefore to the specific proposal to revise the definition of "Covered Claim" within #540, or other language determined to be appropriate to address the need for continuity of protection. The following is the additional language (underlined language) that has been proposed to be added to Section 5, Definitions, within #540.

H. "Covered claim" means the following:

(a) The claimant or insured is a resident of this State at the time of the insured event, provided that for entities other than an individual, the residence of a claimant, insured or policyholder is the State in which its principal place of business is located at the time of the insured event; or

(b) The claim is a first party claim for damage to property with a permanent location in this State.

(c) Notwithstanding any other provision in this Act, an insurance policy issued by a member insurer and later allocated, transferred, assumed by or otherwise made the sole responsibility of another insurer, pursuant to a state statute providing for the division of an insurance company or the statutory assumption or transfer of designated policies and under which there is no remaining obligation to the transferring entity (commonly known as "Division" or "Insurance Business Transfer" statutes), shall be considered to have been issued by a member insurer which is an Insolvent Insurer for the purposes of this Act in the event that the insurer to which the policy has been allocated, transferred, assumed or otherwise made the sole responsibility of is placed in liquidation.

(d) An insurance policy that was issued by a non-member insurer and later allocated, transferred, assumed by or otherwise made the sole responsibility of a member insurer under a state statute described in subsection (a) shall not be considered to have been issued by a member insurer for the purposes of this Act.

4. Does the model law meet the Model Law Criteria? ☒ **Yes** **or** ☐ **No** **(Check one)**

(If answering no to any of these questions, please reevaluate charge and proceed accordingly to address issues).

a. Does the subject of the model law necessitate a national standard and require uniformity amongst all states? ☒ **Yes** **or** ☐ **No** **(Check one)**

If yes, please explain why:

This proposed change is needed to ensure policyholders in all states retain their guaranty fund coverage, which is necessary regardless of how few states adopted changes to their laws to allow IBT and CD transactions.

It should be noted that with respect to guaranty fund coverage for life and health insurance, the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) is suggesting a different approach to address the same issue in the life and health context. NOLHGA's proposal centers around the need for such transaction to require the assuming or resulting insurer to be licensed in all states where the issuing insurer was licensed or ever was licensed to retain the needed coverage for policyholders.

b. Does Committee believe NAIC members should devote significant regulator and Association resources to educate, communicate and support this model law?

☒ **Yes** **or** ☐ **No** **(Check one)**

5. What is the likelihood that your Committee will be able to draft and adopt the model law within one year from the date of Executive Committee approval?

☒ **1** ☐ **2** ☐ **3** ☐ **4** ☐ **5** **(Check one)**

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High Likelihood **Low Likelihood**

Explanation, if necessary:

6. **What is the likelihood that a minimum two-thirds majority of NAIC members would ultimately vote to adopt the proposed model law?**

☒ **1** ☐ **2** ☐ **3** ☐ **4** ☐ **5** **(Check one)**

High Likelihood **Low Likelihood**

Explanation, if necessary: See previous discussion.

7. **What is the likelihood that state legislatures will adopt the model law in a uniform manner within three years of adoption by the NAIC?**

☒ **1** ☐ **2** ☐ **3** ☐ **4** ☐ **5** **(Check one)**

High Likelihood **Low Likelihood**

Explanation, if necessary:

At this juncture, the changes in concepts being considered are simple and because they have the potential to reduce expenses incurred by receivership estates, we believe such changes will be widely supported by all parties.

8. **Is this model law referenced in the NAIC Accreditation Standards? If so, does the standard require the model law to be adopted in a substantially similar manner?**

Not referenced in Accreditation Standards.

9. **Is this model law in response to or impacted by federal laws or regulations? If yes, please explain.**

No.

Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers

A summary of currently identified regulatory considerations follows with no consideration of priority or importance (green underlined font indicates current or completed work by another NAIC committee group). Most of these considerations are not limited to PE owned insurers and are applicable to any insurers demonstrating the respective activities. A summary of the regulatory process has been added to this document since it is being used by individuals less familiar with the state insurance regulatory system, and the results of regulator discussions on how to move forward have been added to specific considerations in blue font. The proposed regulator responses are exposed for a 45-day comment period.

State insurance regulators monitor the solvency of each legal entity insurer, including assessing risks from the broader holding company when an insurer is part of a group, making use of routinely required disclosures, both public, such as the statutory financial statements, and confidential, such as the Risk-Based Capital (RBC) supplemental filing and Holding Company form filings. Regulators also use many analysis and examination tools and procedures for each insurer and/or insurance group. Regulatory responses to the analysis and examination work depend upon the results of those reviews. One specific area of solvency monitoring work focuses on potential acquisitions of a US legal entity insurer, involving a Form A filing. In 2013, guidance was added to the NAIC Financial Analysis Handbook for Form A reviews when a private equity owner was involved, although these considerations are not limited to PE acquisitions. The guidance provides examples of stipulations, both limited time and continuing, regulators could use when approving the acquisition to address solvency concerns, as well as for use in ongoing solvency monitoring. Examples follow:

Limited Time Stipulations:

- Requiring RBC to be maintained at a specified amount above company action level/trend test level. Because capital serves as a buffer that insurers use to absorb unexpected losses and financial shocks, this would better protect policyholders.
- Requiring quarterly RBC reports rather than annual reports as otherwise required by state law.
- Prohibiting any dividends, even ordinary.
- Requiring a capital maintenance agreement or prefunded trust account.
- Enhancing the scrutiny of operations, dividends, investments, and reinsurance by requiring material changes in plans of operation to be filed with the commissioner (including revised projections), which, at a minimum, would include affiliated/related party investments, dividends, or reinsurance transactions to be approved prior to such change.
- Requiring a plan to be submitted by the group that allows all affiliated agreements and affiliated investments to be reviewed, despite being below any materiality thresholds otherwise required by state law. A review of agreements between the insurer and affiliated entities may be particularly helpful to verify there are no cost-sharing agreements that are abusive to policyholder funds assessment.

Continuing Stipulations:

- Requiring prior commissioner approval of material arms-length, non-affiliated reinsurance treaties or risk-sharing agreements.
- Requiring notification within 30 days of any change in directors, executive officers or managers, or individuals in similar capacities of controlling entities, and biographical affidavits and such other information as shall reasonably be required by the commissioner.
- Requiring filing of additional information regarding the corporate structure, controlling individuals, and other operations of the company.

- Requiring the filing of any offering memoranda, private placement memoranda, any investor disclosure statements or any other investor solicitation materials that were used related to the acquisition of control or the funding of such acquisition.
- Requiring disclosure of equity holders (both economic and voting) in all intermediate holding companies from the insurance company up to the ultimate controlling person or individual but considering the burden on the acquiring party against the benefit to be received by the disclosure.
- Requiring the filing of audit reports/financial statements of each equity holder of all intermediate holding companies but considering the burden on the acquiring party against the benefit to be received by the disclosure.
- Requiring the filing of personal financial statements for each controlling person or entity of the insurance company and the intermediate holding companies up to the ultimate controlling person or company. Controlling person could include for example, a person who has a management agreement with an intermediate holding company.

Among many other concepts, regulators are considering the need for any additional stipulations, if there are some stipulations that should be required instead of used subjectively, and use of some stipulations beyond the Form A acquisition process (e.g., for insurers acquired in the past).

RRC Comments "In a Form A transaction" (7 bullet points) – Suggest including these in the referrals to the NAIC Group Solvency Issues (E) Working Group and the NAIC Risk-Focused Surveillance (E) Working Group for consideration when addressing Consideration numbers 1, 2, 4 and 5.

1. Regulators may not be obtaining clear pictures of risk due to holding companies structuring contractual agreements in a manner to avoid regulatory disclosures and requirements. Additionally, affiliated/related party agreements impacting the insurer's risks may be structured to avoid disclosure (for example, by not including the insurer as a party to the agreement).

   Regulator discussion results:
   - Refer this item to the NAIC Group Solvency Issues (E) Working Group. Items discussed:
     - Instead of requiring for all Form A acquisitions to provide additional disclosures, structure an optional disclosure requirement that can be used when unresolved regulatory concerns exist with the acquisition. For example:
       - Disclosures to allow regulators to assess the goal of the potential owner in acquiring the insurer, how the potential owner will be paid and in what amounts, and the ability of the potential owner to provide capital support as needed.
       - Copies of disclosures provided to the potential owner's investors.
     - Provide training as needed to states with less experience reviewing complex Form A transactions and refer those states to more experienced states for live help.
       - These options include highlighting the need to use external expertise for complex transactions, especially to understand non-U.S. affiliations and when assessing multiple complex Form A applications, and at the expense of the Form A applicant.

   AIC Comment (recommended 2 items) – Suggest including this recommendation in the referral to the NAIC Group Solvency Issues (E) Working Group for its work on Consideration #1.

- Recommendation: The Working Group should assess, among other items: (i) the need to provide regulatory certainty *vis a vis* when and on what basis additional disclosures could be required; and (ii) whether the additional disclosures would extend approval timelines. We believe such items are critical to insurers being able to access the capital markets effectively and efficiently.

2. Control is presumed to exist where ownership is >=10%, but control and conflict of interest considerations may exist with less than 10% ownership. For example, a party may exercise a controlling influence over an insurer through Board and management representation or contractual arrangements, including non-customary minority shareholder rights or covenants, investment management agreement (IMA) provisions such as onerous or costly IMA termination provisions, or excessive control or discretion given over the investment strategy and its implementation. Asset-management services may need to be distinguished from ownership when assessing and considering controls and conflicts.

Regulator discussion results:
- Refer this item to the NAIC Group Solvency Issues (E) Working Group. Regulators recognized the integral connection of the first two considerations. Items discussed:
    - An emphasis on training and providing detailed examples to address the complexity and creativity involved in some of these Form A agreements and holding company structures.
    - It is not practical to get copies of operating agreements from every entity in a group to assess control impacts to the insurers. Consider ways of better targeting the pertinent agreements to assess, including a potential list of questions about less than 10% owners for use when considering Form A applications and/or ongoing analysis.
    - Consider if Form B (Insurance Holding Company System Annual Registration Statement) disclosure requirements should be modified to address these considerations.

AIC Comment (2 primary concerns) – Suggest asking the AIC to follow the work of the NAIC Group Solvency Issues (E) Working Group on Consideration #2 and make comments on specific recommendations if needed.
- Concerns: The 10% presumption of control needs to remain; and contractual terms contained in service agreements that are negotiated on an arm's length basis are not sufficient to convey the power to direct or cause the direction of an insurer, so long as they are subject to the ultimate supervision and control by the insurer.

3. The material terms of the IMA and whether they are arm's length or include conflicts of interest —including the amount and types of investment management fees paid by the insurer, the termination provisions (how difficult or costly it would be for the insurer to terminate the IMA) and the degree of discretion or control of the investment manager over investment guidelines, allocation, and decisions.

Regulator discussion results:
- Refer this item to the NAIC Risk-Focused Surveillance (E) Working Group. Regulators recognized similar dynamics to the first two considerations, but this Working Group was selected because it is already currently focused on a project involving affiliated agreements and Form D filings. Items discussed:
    - Consider training and examples, such as unique termination clauses and use of sub-advisors with the potential for additive fees, and strategies to address these.

        - This included addressing pushback on obtaining sub-advisor agreements as Form D disclosures and some optional disclosures for the Form A.
    - Given the increasing prevalence of bespoke agreements, does it make sense to tie this work in to the work of the NAIC Valuation of Securities (E) Task Force and/or the NAIC Securities Valuation Office? If yes, how best to do so?
    - Surplus Notes and appropriate interest rates given their special regulatory treatment, including whether floating rates are appropriate; follow any Statutory Accounting Principles (E) Working Group projects related to this topic and provide comments needed.

RRC Comments "With respect to an Investment Management Agreement (IMA" (3 bullet points) - Suggest including these in the referral to the NAIC Risk-Focused Surveillance (E) Working Group for Consideration #3.

AIC Comments on "Conflict of Interest, Fees, Termination" (3 individual comments) – Suggest including these comments in the referral to the NAIC Risk-Focused Surveillance (E) Working Group for its work on Consideration #3.

4. Owners of insurers, regardless of type and structure, may be focused on short-term results which may not be in alignment with the long-term nature of liabilities in life products. For example, investment management fees, when not fair and reasonable, paid to an affiliate of the owner of an insurer may effectively act as a form of unauthorized dividend in addition to reducing the insurer's overall investment returns. Similarly, owners of insurers may not be willing to transfer capital to a troubled insurer.
    a. Life Actuarial (A) Task Force (LATF) work addresses this – helping to ensure the long-term life liabilities (reserves) and future fees to be paid out of the insurer are supported by appropriately modeled assets.

Regulator discussion results:

- In addition to LATF's work, refer this item to the NAIC Risk-Focused Surveillance (E) Working Group, as it is already looking at some of this work related to affiliated agreements and fees. Items discussed:
    - Capital maintenance agreements, suggesting guidance for the appropriate entities to provide them and considering ways to make them stronger.

5. Operational, governance and market conduct practices being impacted by the different priorities and level of insurance experience possessed by entrants into the insurance market without prior insurance experience, including, but not limited to, PE owners. For example, a reliance on TPAs due to the acquiring firm's lack of expertise may not be sufficient to administer the business. Such practices could lead to lapse, early surrender, and/or exchanges of contracts with in-the-money guarantees and other important policyholder coverage and benefits.
    a. The NAIC Financial Analysis Handbook includes guidance specific to Form A consideration and post approval analysis processes regarding PE owners of insurers (developed previously by the Private Equity Issues (E) Working Group).

Regulator discussion results:

- Regulators considered referring this consideration to the NAIC Risk-Focused Surveillance (E) Working Group but opted to keep developing more specific suggestions for now. Items discussed:

- Consider optional Form A disclosures and guidance for less experienced states; review EU conduct of business language and consider if similar concepts would help target the optional use.
- Consider more detailed guidance for financial examinations.
- Besides just inexperience, the consideration also includes intentional actions that ignore known concerns to achieve owner's results; might need to consider Market Conduct group(s).

6. No uniform or widely accepted definition of PE and challenges in maintaining a complete list of insurers' material relationships with PE firms. (UCAA (National Treatment WG) dealt with some items related to PE.) This definition may not be required as the considerations included in this document are applicable across insurance ownership types.

Regulator discussion results:

- Regulators do not believe a PE definition is needed, as the considerations are activity based and apply beyond PE owners.

7. The lack of identification of related party-originated investments (including structured securities). This may create potential conflicts of interests and excessive and/or hidden fees in the portfolio structure, as assets created and managed by affiliates may include fees at different levels of the value chain. For example, a CLO which is managed or structured by a related party.
    a. An agenda item and blanks proposal are being re-exposed by SAPWG. Desire for 2022 year-end reporting to include disclosures identifying related-party issuance/acquisition.

Regulator discussion results:

- Regulators are comfortable the SAPWG's work is sufficient as a first step since it involves code disclosures to identify various related party issues. They also recognize that existing and/or referred work at the Risk-Focused Surveillance (E) Working Group may address some items in this consideration. Once regulators work with these SAPWG disclosures and other regulatory enhancement, further regulatory guidance may be considered as needed.

8. Though the blanks include affiliated investment disclosures, it is not easy to identify underlying affiliated investments and/or collateral within structured security investments. Additionally, transactions may be excluded from affiliated reporting due to nuanced technicalities. Regulatory disclosures may be required to identify underlying related party investments and/or collateral within structured security investments. This would include, for example, loans in a CLO issued by a corporation owned by a related party.
    a. An agenda item and blanks proposal are being re-exposed by SAPWG. The concept being used for investment schedule disclosures is the use of code indicators to identify the role of the related party in the investment, e.g., a code to identify direct credit exposure as well as codes for relationships in securitizations or similar investments.

Regulator discussion results:

- Like the previous consideration, regulators are looking forward to using these code disclosures to help target areas for further review. However, specific to CLO/structured security considerations, regulators support a referral to the Examination Oversight (E) Task Force. Specific items discussed include:

- Since investors in CLOs obtain monthly collateral reports, regulators should consider asking for such reports when concerns exist regarding a company's potential exposure to affiliated entities within their CLO holdings.
- Regulators would like to have more information regarding the underlying portfolio companies affiliated with a CLO manager to help quantify potential exposure between affiliates and related parties.
- Regulators request NAIC staff to consider their ability to provide tools and/or reports to help regulators target CLOs/structured securities to consider more closely.

RRC Comments on "collateralized loan obligations (CLOs)" (2 bullets) – Suggest including these in the referrals to the NAIC Examination Oversight (E) Task Force and the NAIC Risk-Focused Surveillance (E) Working Group for Consideration numbers 7, 8 and 9, but also sending to the NAIC Statutory Accounting Principles (E) Working Group for its existing work related to these Considerations.

9. Broader considerations exist around asset manager affiliates (not just PE owners) and disclaimers of affiliation avoiding current affiliate investment disclosures. A new Schedule Y, Pt 3, has been adopted and is in effect for year-end 2021. This schedule will identify all entities with greater than 10% ownership – regardless of any disclaimer of affiliation - and whether there is a disclaimer of control/disclaimer of affiliation. It will also identify the ultimate controlling party.
    a. Additionally, SAPWG is developing a proposal to revamp Schedule D reporting, with primary concepts to use principles to determine what reflects a qualifying bond and to identify different types of investments more clearly. For example, D1 may include issuer credits and traditional ABS, while a sub-schedule of D1 could be used for additional disclosures for equity-based issues, balloon payment issues, etc. This is a much longer-term project, 2024 or beyond.

Regulator discussion results:

- Regulators recognize the new Schedule Y, Part 3, will give them more insights for owners of greater than 10%, but it does not provide insights for owners of less than 10%. However, regulators also recognize that existing and/or referral work of the Risk-Focused Surveillance (E) Working Group may help with some of this dynamic. Additionally, since the SAPWG 2022 code project and its longer-term Schedule D revamp project will help provide further disclosures that will assist with this consideration, regulators are comfortable waiting to see if further regulatory guidance is needed after using the resulting disclosures and other enhancements from these projects.
    - Specific to owners of less than 10%, regulators discussed the April 19, 2022, Insurance Circular Letter No. 5 (2022) sent by the New York Department of Financial Services to all New York domiciled insurers and other interested parties. This letter highlights that avoiding the levels deemed presumption of control, e.g., greater than 10% ownership, does not create a safe harbor from a control determination and the related regulatory requirements. The circular letter was distributed to all MWG members and interested regulators.

10. The material increases in privately structured securities (both by affiliated and non-affiliated asset managers), which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency. (The NAIC Capital Markets Bureau continues to monitor this and issue regular reports, but much of the work is complex and time-intensive with a lot of manual research required. The NAIC Securities Valuation Office

will begin receiving private rating rationale reports in 2022; these will offer some transparency into these private securities.)

a. LATF's exposed AG includes disclosure requirements for these risks as well as how the insurer is modeling the risks.
b. SVO staff have proposed to VOSTF a blanks proposal to add market data fields (e.g., market yields) for private securities. If VOSTF approves, a referral will be made to the Blanks WG.

Regulator discussion results:

- Regulators focused on the need to assess whether the risks of these investments are adequately included in insurers' results and whether the insurer has the appropriate governance and controls for these investments. Regulators discussed the potential need for analysis and examination guidance on these qualifications.
- To assist regulators in identifying concerns in these investments, regulators expressed support for the VOSTF proposal to obtain market yields to allow a comparison with the NAIC Designation. Once such data is available, regulators ask NAIC staff to develop a tool or report to automate this type of initial screening. Also, regulators again recognized the SAPWG Schedule D revamp work will help in identifying other items for initial screening.
- The regulators discussed LATF's exposed AG, noting the Actuarial Memorandum disclosures that would be required for these privately structured securities along with the actuarial review work, and recognizing how those would be useful for analysts and examiners when reviewing these investments. Additionally, the Valuation and Analysis (E) Working Group would be able to serve as a resource for some of these insights for states without in house actuaries.
- As a result of the above discussions, regulators agreed to a referral to the Examination Oversight (E) Task Force to address the disclosures that will be available from LATF's exposed AG. They agreed to wait for any further work or referral until they have an opportunity to work with the results of the VOSTF proposal and the SAPWG Schedule D revamp project.

RRC Comments on "privately structured securities" (2 bullets, 1 with 2 sub-bullets) – Suggest including these in the referral to the NAIC Examination Oversight (E) Task Force for Consideration #10 but also sending to the NAIC Valuation of Securities (E) Task Force for its existing work related to this Consideration.

AIC Comment on "Privately Structured Securities" (6 bullets) – Suggest asking the AIC to follow the work of the NAIC Examination Oversight (E) Task Force and the NAIC Valuation of Securities (E) Task Force and provide comments on specific recommendations if needed.

RRC Comment on the work by the NAIC Life Actuarial (A) Task Force (LATF) – Suggest adopting this recommendation as an addition to the Regulatory Discussion results and sending the referral.

- Recommendation: Since reserves are not intended to capture tail risk, refer this item to the NAIC RBC Investment Risk and Evaluation (E) Working Group and monitor the Working Group's progress.

11. The level of reliance on rating agency ratings and their appropriateness for regulatory purposes (e.g., accuracy, consistency, comparability, applicability, interchangeability, and transparency).
    a. VOSTF has previously addressed and will continue to address this issue. A small ad hoc group is forming (key representatives from NAIC staff, regulators, and industry) to develop a framework for assessing rating agency reviews. This will be a multi-year project, will include discussions with rating agencies, and will include the inconsistent meanings of ratings and terms.

Regulator discussion results:

- Regulators agreed to monitor the work of the ad hoc group in lieu of any specific recommendations at this time. Recognizing this will likely be a multi-year project, regulators reserve the right to raise specific concerns that may arise as the various NAIC committee groups work to address this list of considerations.

12. The trend of life insurers in pension risk transfer (PRT) business and supporting such business with the more complex investments outlined above. (Enhanced reporting in 2021 Separate Accounts blank will specifically identify assets backing PRT liabilities.) Considerations have also been raised regarding the RBC treatment of PRT business.
    a. **LATF has exposed an Actuarial Guideline** to achieve a primary goal of ensuring claims-paying ability even if the complex assets (often private equity-related) did not perform as the company expects, and a secondary goal to require stress testing and best practices related to valuation of non-publicly traded assets (note – LATF's considerations are not limited to PRT). Comment period for the 2nd exposure draft ends on May 2.

       Regulator discussion results:
       - Regulators focused on the need to have disclosures on the risks to the General Account from the Separate Account PRT business – for guarantees but also reporting/tracking when the Separate Account is not able to support its own liabilities. Regulators noted the need to address the differences between buy in PRT transactions and buy out.
       - Regulators are comfortable LATF is addressing the reserve considerations. To address the disclosure considerations, regulators support sending a referral to the Statutory Accounting Principles (E) Working Group since regulators suggested it be an item in the Notes to Financial Statements. (Regulators noted it might help to discuss such disclosure concepts with LATF's Valuation Manual 22 (A) Working Group.)
         - While the exposed AG is not limited to PRT, and general disclosures may be helpful, regulators recognized additional and/or more specific disclosures may be needed for PRT business.

    b. Review applicability of Department of Labor protections resulting for pension beneficiaries in a PRT transaction.

       Regulator discussion results:
       - Regulators discussed concerns regarding potential differences between the pension benefit and the group annuity benefit in the PRT transaction.
       - Regulators directed NAIC staff to further research this item for the MWG to address in the near future, including potential discussions with Department of Labor representatives.

    c. Review state guaranty associations' coverage for group annuity certificate holders (pension beneficiaries) in receivership compared to Pension Benefit Guaranty Corporation (PBGC) protection.
       i. NOLHGA provided 2016 study of state guaranty fund system vs. PBGC.

       Regulator discussion results:
       - Regulators recognized the difficulty in comparing the state guaranty system to the Pension Benefit Guarantee Corporation, as detailed in the NOLHGA study. However,

they agreed policyholders should appreciate the benefit of having solvency regulators actively monitoring and working with the insurance companies in an attempt to prevent the need for any guaranty fund usage, as standard corporations holding pension liabilities have significantly less regulatory oversight.
- Regulators found the NOLHGA study responsive to this consideration, thus they suggested no further action.

d. "Considerations have also been raised regarding the RBC treatment of PRT business."
Regulator discussion results:
- Regulators recognized the work of the Longevity Risk Transfer (LRT) Subgroup of the Life Risk-Based Capital (E) Working Group covers PRT business. A new LRT charge was included in the 2021 Life Risk-Based Capital (LRBC) formula. Regulators agreed the results of this new charge should be monitored.
- While regulators agreed to follow the work of the LRT Subgroup, they suggested no further action at this time.

13. Insurers' use of offshore reinsurers (including captives) and complex affiliated sidecar vehicles to maximize capital efficiency, reduce reserves, increase investment risk, and introduce complexities into the group structure.
    a. LATF's exposed AG was modified to require the company to provide commentary on reinsurance collectability and counterparty risk in the asset adequacy analysis memorandum. The original concept of requiring life insurers to model the business itself even if it uses these mechanisms to share/transfer risk was deferred to allow time to consider and address concerns over potential violations with EU/UK covered agreements and the 2019 revisions to NAIC Models 785 and 786.

Regulator discussion results:
- Regulators held candid conversations about the need to understand why insurers are using these types of offshore reinsurers. If there are problems in the U.S. regulatory system that are driving insurers to utilize offshore reinsurers (e.g., "excess" reserves), we should know of those problems so we can consider if there are appropriate changes to make.
- If there are other drivers, per the common theme in the regulators' review of this list of considerations, there isn't a presumption that the use of these transactions is categorically bad. Rather, there is a need to understand the economic realities of the transactions so the regulators can effectively perform their solvency monitoring responsibilities.
    - Regulators discussed the potential concept of additional Holding Company Act requirements if these are affiliated reinsurers, disclosing the insurer benefits (reserves, capital, etc.).
- Regulators deferred specifying action on this item at this time, instead noting the desire to have meetings with industry representatives using these transactions and regulators from some of the offshore jurisdictions to gain more insights.

Northwestern Mutual Comment (2 cautions) – Suggest including these cautions as part of the MWG's future discussions and work for this Consideration.
- Caution: Reinsurance transactions can and often do serve a valuable function by reallocating risk. However, offshore reinsurance can also result in lower total reserves and capital, reduced state regulatory oversight, and diminished stakeholder transparency from what would be required by the statutory accounting and risk-based capital requirements the NAIC has established to protect policyholders in the United States.

- Caution: Without progress and action on the item pertaining to offshore reinsurance, the Working Group's progress on other MWG Considerations could further incentivize even more utilization of offshore reinsurance transactions and undercut the NAIC's efforts to close other solvency regulatory gaps domestically. In the long run, a system that encourages companies to transfer business to a related offshore entity in order to alter their reserves and capital from uniform standards diminishes the strength of reserve and capital regulation in the United States. If capital standards are deemed to be too conservative in the US, they should be addressed transparently and uniformly through the NAIC and not through the alternate means of offshore reinsurance.

- **Additional regulator discussion result:**
  - Similar to the result of discussions for the 13th consideration, regulators expressed a desire to meet with various industry representatives to discuss the incentives behind private equity ownership of insurers and conversely the concerns other industry members may have with such ownership. Regulators believe the insights from these conversations will benefit their ability to monitor and, when necessary, contribute to the work occurring in the various NAIC committee groups regarding these considerations.

Adopted by the Mutual Recognition of Jurisdictions (E) Working Group on June 29, 2022

NAIC List of Jurisdictions that Recognize and Accept the Group Capital Calculation

Reciprocal Jurisdictions (Model #440, Section 4L(2)(c)

Jurisdiction	Group-Wide Supervisor	Effective Date	Model #440, Section 4L(2)(e) Determination Explanatory Note
Member States of the European Union	Respective Member State Supervisory Authorities	January 1, 2022	
United Kingdom (UK)	Prudential Regulation Authority of the Bank of England (PRA)	January 1, 2022	
Bermuda	Bermuda Monetary Authority (BMA)	January 1, 2022	
Japan	Financial Services Agency (FSA)	January 1, 2022	
Switzerland	Financial Market Supervisory Authority (FINMA)	January 1, 2022	

Recognize and Accept Jurisdictions (Model #440, Section 4L(2)(d)

Jurisdiction	Group-Wide Supervisor	Effective Date	Model #440, Section 4L(2)(e) Determination Explanatory Note
None currently			

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Group Capital Calculation. On December 9, 2020, the NAIC adopted revisions to the *Insurance Holding Company System Regulatory Act* (#440) and *Insurance Holding Company System Model Regulation with Reporting Forms and Instructions* (#450). These revisions implement the Group Capital Calculation (GCC) filing requirements for insurance groups at the level of the ultimate controlling person for the purposes of evaluating solvency at the group level. The revisions specifically provide that the requirement to file the NAIC's GCC applies to U.S.-based groups, while a group headquartered outside the U.S. is exempt from the GCC (subject to limited exceptions detailed in the *Process for Evaluating Jurisdictions that Recognize and Accept the Group Capital Calculation*) if its groupwide supervisor "recognizes and accepts" the GCC for U.S. groups doing business in that jurisdiction.

List of Jurisdictions that Recognize and Accept the GCC. The Mutual Recognition of Jurisdictions (E) Working Group will evaluate non-U.S. jurisdictions in accordance with the "Recognize and Accept" Process. A list of "Recognize and Accept" Jurisdictions is published through the NAIC committee process. Sections 21D and 21E of Model #450 provide a general framework for how the process to identify "Recognize and Accept" Jurisdictions will work and specifically contemplates the development of a list of such jurisdictions through the NAIC Committee Process.

NAIC Listing Process. Section 4L(2) of Model #440 provides two ways a non-U.S. jurisdiction may meet the standards for its insurance groups to be exempt from the GCC:

(a) If the jurisdiction has been determined to be a Reciprocal Jurisdiction for purposes of credit for reinsurance, which includes a requirement that the jurisdiction "recognizes the U.S. state regulatory approach to group supervision and group capital" (Model #440, Section 4L(2)(c)); or

(b) If the jurisdiction has otherwise been determined to recognize and accept the GCC by procedures specified in regulation.

Evaluation of Reciprocal Jurisdictions. Under Section 4L(2)(c) of Model #440, Reciprocal Jurisdictions that recognize the U.S. state regulatory approach to group supervision and group capital are exempt from the GCC. Because a "recognize and accept" evaluation by the Mutual Recognition of Jurisdictions (E) Working Group is already part of the Reciprocal Jurisdiction review process, all Reciprocal Jurisdictions designated by the NAIC through that review process are also automatically designated as "Recognize and Accept" Jurisdictions. Likewise, in view of the terms of the EU and UK Covered Agreements, all EU Member States and the UK are automatically designated "Recognize and Accept" Jurisdictions. If there is a material change to the terms of the U.S.-EU or U.S.-UK Covered Agreement, or if the United States enters into a new covered agreement with one or more non-U.S. jurisdictions, the Mutual Recognition of Jurisdictions (E) Working Group will consider, and will consult with FIO and USTR regarding, whether and how the applicability of the procedures in this document may apply.

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Prudential Oversight and Solvency Monitoring. Section 4L(2)(e) of Model #440 directs a lead state commissioner to require the group capital calculation for U.S. operations of any non-U.S. based insurance holding company system based in a "Recognize and Accept" Jurisdiction if, after any necessary consultation with other supervisors or officials, the commissioner deems such a "subgroup" calculation to be appropriate for prudential oversight and solvency monitoring purposes or for ensuring the competitiveness of the insurance marketplace. Section 21E(1) of Model #450 provides that to assist with such a determination, the "Recognize and Accept" List will also identify whether a listed jurisdiction requires a group capital filing for any U.S. based insurance group's operations in that jurisdiction. The NAIC will identify such jurisdictions on the "Recognize and Accept" List, and may include an explanatory note in cases where a simple "Yes" or "No" response does not adequately describe the jurisdiction's requirements. States may rely on this List when making determinations under Section 4L(2)(e) of Model #440.

The specific details of the GCC Recognize and Accept process can be found in the *Process for Evaluating Jurisdictions that Recognize and Accept the Group Capital Calculation*.

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MEMORANDUM

TO: Financial Condition (E) Committee

FROM: Statutory Accounting Principles (E) Working Group

DATE: July 21, 2022

RE: Related Party Reporting

This memorandum intends to provide information to the Financial Condition (E) Committee on recent adoptions by the Statutory Accounting Principles (E) Working Group and the Blanks (E) Working Group regarding the identification of related party involvement with investments. This is preliminary communication to the Committee, as the revisions will impact all insurance reporting entities and the discussion included affiliate identification. Submission of the statutory and blanks revisions for adoption consideration to the Accounting Practices and Procedures (E) Task Force and Financial Condition (E) Committee will occur at the Summer National Meeting. The intent is to provide information on the action as well as key discussion elements to allow Committee members to receive this information prior to considering action during the Summer National Meeting.

In conjunction with recent recommendations from the Macroprudential (E) Working Group regarding the risk of certain investments that involve related parties, in May 2022, the Statutory Accounting Principles (E) Working Group adopted its agenda item *2021-21: Related Party Reporting*.

The primary goal of this agenda item was to incorporate new reporting requirements for investment transactions with related parties in order to provide more transparency into the nature of the involvement of related parties. For example, it allows regulators to understand whether the investment involves credit exposure to related parties or whether the investment involves a related party in the origination or servicing of the investment. This reporting applies to all investments involving related parties, regardless of whether they meet the definition of an affiliate per Model #440.

With an effective date of Dec. 31, 2022, schedules: B – Mortgage Loans, D – Long-Term Bonds, DB – Derivatives, BA – Other Long-Term Invested Assets, DA – Short-Term Investments, E2 – Cash Equivalents, and DL – Securities Lending Collateral Assets will require the identification of related party involvement for every investment.

Investments Involving Related Parties:

Required for all investments involving related parties including, but not limited to, those captured as affiliate investments. This disclosure intends to capture information on investments held that reflect interactions involving related parties, regardless of whether the related party meets the affiliate definition, or the reporting entity has received domiciliary state approval to disclaim control / affiliation.

Enter one of the following codes to identify the role of the related party in the investment.

1. Direct loan or direct investment (excluding securitizations) in a related party, for which the related party represents a **direct credit exposure**.

2. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies **involving a relationship with a related party** as sponsor, originator, manager, servicer, or other similar influential role **and for which 50% or more of the underlying collateral represents investments in or direct credit exposure to related parties.**

3. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies **involving a relationship with a related party** as sponsor, originator, manager, servicer, or other similar influential role and **for which less than 50% (including 0%) of the underlying collateral represents investments in or direct credit exposure to related parties**.

4. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies in which the structure reflects an in-substance related party transaction but does not involve a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role.

5. The investment is identified as related party, but the role of the related party represents a different arrangement than the options provided in choices 1-4.

6. The investment does not involve a related party.

   [**Commentary** – While feedback from interested parties indicated that most investments do not involve a related party, the Statutory Accounting Principles (E) Working Group communicated support to make the related party identification field **mandatory**, thus a "blank" indication will not be permitted. This eliminates ambiguity on whether an investment does not have a related party involvement or whether the component of the investment schedule was inadvertently not completed.]

In addition to the new reporting granularity, the agenda item also adopted clarifications to SSAP No. 25 and *SSAP No. 43R—Loan-Backed and Structured Securities* to make clear that the existing affiliate definition applies to all types of entities, including securitizations. Existing guidance already made clear that control may exist through arrangements other than voting interests, such as in the case of a limited partnership where control is typically held by the general partner. The adopted clarifications simply add specificity around the application of this existing guidance to other types of non-voting entities. For example, securitization entities are typically controlled through non-voting arrangements. To the extent that such control is held by the reporting entity or its affiliates, then the securitization entity and any investments in it would be deemed affiliated.

While both the Statutory Accounting Principles (E) Working Group and the Blanks (E) Working Group have adopted the revisions, with a Dec. 31, 2022, effective date, consideration by the Accounting Practices and Procedures (E) Task Force and the Financial Condition (E) Committee will occur during the Summer National Meeting. Although industry comments were submitted and considered by the Statutory Accounting Principles (E) Working Group on the proposed statutory accounting changes, the statutory revisions and support for the reporting revisions were unanimously adopted with limited changes from the exposure. No industry comments were presented at the Blanks (E) Working Group, and the reporting revisions were also adopted unanimously by that Group.

Key discussion elements in response to comments considered at the Statutory Accounting Principles (E) Working Group are summarized below.

- **There are no revisions that changes the current definition of an affiliate or reporting on the affiliate reporting line.** Although industry comments suggested that the statutory additions require a "look through" exercise that did not exist, existing statutory guidance and the holding company act already state that control includes "possession, directly or **indirectly**, of the power to direct or cause the direction of the management and policies of the investee" and that "control shall be presumed to exist if a reporting entity **and its affiliates** directly or **indirectly**, own, control, hold the power to vote, or hold proxies **representing 10% or more** of the voting interest of the entity". The added statutory guidance did not change this existing guidance, and therefore should not introduce any new burden or requirement on reporting entities.

- Although industry comments on what should be captured on the affiliate reporting line were submitted, that discussion was beyond the scope of the current statutory revisions and the new reporting codes to identify the involvement of related parties with investments. **The new electronic columns to capture related party relationships is applicable to all reporting lines regardless of affiliate determination.**

- **Information within submitted industry comments indicating that affiliation determination under the holding company act is based solely on the voting rights of an equity holder were incorrect under existing guidance**. The definition of an affiliate and control per the Holding Company Act (Model 440) and SSAP No. 25 are consistent and detailed below. An affiliate is determined through control, and control can occur through other means besides ownership of voting securities. **Although ownership of 10% of voting securities results in a presumption of control, voting securities are clearly not the sole basis for determining control.** For many types of entities, control is not typically held through voting securities which has long been recognized under both GAAP and statutory accounting principles. As has always been the case, determination of the affiliation of an investment is based on an evaluation of control of the investee, whether through voting interests or other means. The adopted statutory revisions do not change this guidance in any way.

- Verbal comments received during the call also indicated even when an entity has been appropriately identified as an affiliate (and reported on Schedule Y), that some reporting entities may not be reporting debt investments issued by those affiliates as affiliated investments. While Working Group members stated that this is not an appropriate application of the reporting guidance, it directed staff to evaluate any further clarifications or examples that may be warranted to make clear that all investments in affiliates (including debt investments) should be reported as affiliated, and/or to provide more specificity on how to evaluate whether non-voting arrangements result in control.

Excerpts from the Holding Company Act as well as SSAP No. 25 are provided to further detail the existing guidance regarding determination of control.

Excerpt from Holding Company Act:

A. "Affiliate." An "affiliate" of, or person "affiliated" with, a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

C. "Control." The term "control" (including the terms "controlling," "controlled by" and "under common control with") **means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or nonmanagement services, or otherwise**, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10%) or more of the voting securities of any other person. This presumption may be rebutted by a showing made in the manner provided by Section 4K that control does not exist in fact. The commissioner may determine, after furnishing all persons in interest notice and opportunity to be heard and making specific findings of fact to support the determination, that control exists in fact, notwithstanding the absence of a presumption to that effect.

Excerpt from SSAP No. 25—Affiliates and Other Related Parties

5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

6. **Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results**

<u>in a reliance relationship (d) by common management, or (e) otherwise</u>. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

In summary, this memorandum intends to provide preliminary information to the Financial Condition (E) Committee on revisions to improve reporting of investments that involve related parties. Questions on the adopted revisions or discussions that occurred can be directed to Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group or Kevin Clark, Vice-Chair of the Statutory Accounting Principles (E) Working Group. Submission of the adopted statutory accounting and blanks revisions for adoption consideration will be presented to the Accounting Practices and Procedures (E) Task Force and the Financial Condition (E) Committee during the Summer National Meeting.

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

TO: Financial Condition (E) Committee

FROM: Statutory Accounting Principles (E) Working Group

DATE: July 21, 2022

RE: Principles Based Bond Definition

This memo has been prepared to update the Committee on the SAPWG agenda item #2019-21, commonly referred to as the Principles Based Bond Definition Project, which will result in principally defining investments permitted to be reported on *Schedule D-1: Long-Term Bonds*. The Statutory Accounting Principles (E) Working Group, and key industry representatives, have been working dedicatedly on this project since 2020. Significant progress has been achieved, and the Working Group anticipates having adopted guidance in effect for year-end 2024 or year-end 2025. The project is robust and will include significant revisions to the existing guidance for bond reporting as well as significant revisions to the reporting of bond investments on Schedule D-1.

History / Reason to Change

Several factors have led to increased innovation in insurers' investment portfolios. This includes the low-interest rate environment that has increased pressure to seek higher yields, as well as increasing partnerships between insurers and asset originators that has enabled insurers access to more innovative asset types and structures. Often, these innovative asset structures involve the securitization of an increasing variety of collateral, which transforms the underlying collateral into a bond. Although there are benefits from increased yields, the evolution has created challenges for regulators to understand the risks, and underlying sources of cash flows, involved in bond portfolios.

The current statutory accounting bond definition allows any security that represents a creditor relationship to qualify for bond reporting as a bond or loan-backed or structured security. The current focus is on legal form, rather than substance. As a result, the opportunity exists to report any asset as a bond by acquiring it through a special purpose vehicle (SPV) as a debt instrument from the SPV. The insurer may or may not be in a different economic position as if they held the underlying assets directly. In addition to the opportunity, there is also an RBC incentive to classify otherwise non-qualifying assets as bonds. Underlying assets may be inadmissible or may receive worse RBC charges (equities) if held directly on the insurer's balance sheet. Regulators currently have little transparency into whether assets classified as bonds incorporate risks that do not reflect traditional bond risk.

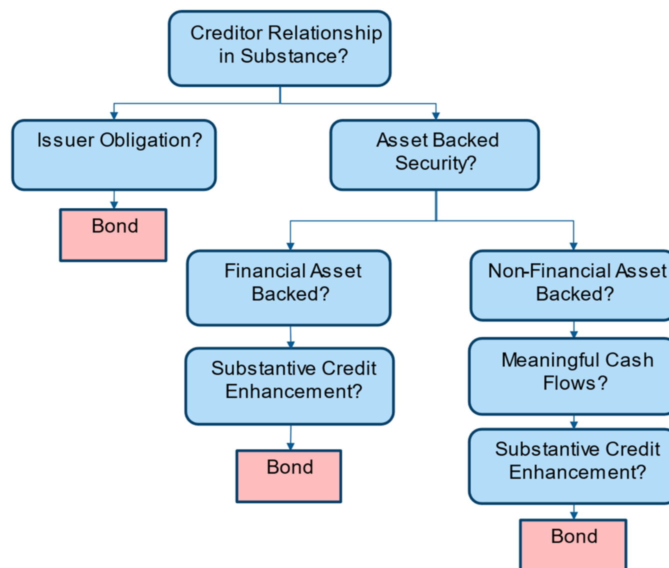
The intent of this project is to establish principle-based guidance for determining bonds, with a focus of substance over form, in such a manner so that the framework will be more "futureproof." In other words, that the principles established will be able to work for an increasingly innovative market and will provide regulators and other financial statement users with the transparency to understanding the risks present in an insurer's investment portfolio.

Proposed Principles-based Bond Definition

Under the proposed definition, 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**.** Although this definition may seem like existing guidance, the proposed definition is explicit that the investment shall represent a creditor relationship in substance, not just legal form. Furthermore, it specifies that investments with equity-like characteristics or that represent ownership interests in substance, are not bonds.

Application of the bond definition is described below, however, may best be visualized in the following simplified flowchart. This simplified visual collapses certain steps in the decision for simplicity but showcases the overarching concepts of the principles-based bond definition.

Bond Principles Flowchart



<u>Issuer Obligations or Asset Backed Securities:</u>
Bonds are either issuer obligations or asset-backed securities. Investments that do not fit within either category or that are not named as specific non-bond inclusions shall not be reported as bonds. (Examples of non-bond named inclusions would include certificates of deposit and SVO-Identified Bond ETFs which have historically been reported on Schedule D-1.)

- **Issuer Obligation:** A bond will be classified as an **issuer obligation** if the investment represents an instrument where the repayment is primarily supported by the general creditworthiness of an operating entity (an entity with underlying operations), and the note is an obligation that has direct or indirect recourse to the operating entity. (Examples of Issuer Obligations include U.S. Treasuries, corporate debt, or securities where repayment is supported by an underlying contractual obligation of an operating entity.)

- **Asset Backed Security:** A bond will be classified as an **asset backed security (ABS),** if the instruments are issued by entities that have a primary purpose of raising debt capital backed by collateral (financial assets or non-financial assets) that provides cashflows to service debt. All ABS are required to have substantive credit enhancement.

  - **Substantive Credit Enhancement**: All ABS securities (regardless of backed by financial or non-financial assets) must result in the holder being in a different economic position than had they held the underlying collateral directly. If the holder would be in the same economic position if they held the underlying collateral directly, the investment is not an ABS and not a bond. Rather, the characteristics are more aligned with that of the collateral itself. This requirement will ensure RBC arbitrage will be curtailed as the security must explicitly possess bond-like risks. In order to support that an insurer is in a different economic position, there must be <u>substantive credit enhancement</u>, through overcollateralization / subordination or other form of guarantee or recourse, to support that the underlying collateral risks have been recharacterized to bond risk. In essence, in a securitization, there must be a level of subordination that is expected to absorb losses **<u>before</u>** the debt instrument being evaluated would be expected to absorb losses.

There are additional assessments required for ABS based on whether the ABS is backed by financial or non-financial assets:

- **Financial assets** are cash, evidence of an ownership interest in an entity, or a contract that conveys a right to receive cash or another financial instrument or exchange other financial instruments on potentially favorable terms. Loans or receivable-backed securities (RMBS, CMBS, CLOs, etc.) are financial asset-backed as the collateral represents rights to payment without any further performance obligation of any other party.

- **Non-financial assets** reflect collateral assets that are expected to generate a meaningful source of cash flows for repayment of the bond through use, licensing, leasing, servicing or management fees, or other similar cash flow generation. When a performance obligation exists, the assets represent non-financial assets, or a means through which non-financial assets produce cash flows once the performance obligation has been satisfied. Examples include cash flows from leases, royalties, licensing, etc.

Meaningful Cashflow Determination for Non-Financial Collateral backed ABS:
Non-financial assets backing ABS must be expected to generate meaningful cash flows to service the debt, other than through the sale or refinancing of assets. However, reliance on cash flows from the sale or refinancing of does not preclude an ABS from being classified as a bond as long as the meaningful cash flow requirement is met. The bond definition includes a practical expedient so if less than 50% of contractual principle and interest relies on refinance or sale of the collateral assets, then it qualifies as producing meaningful cash flows. The intent of the meaningful cash flow requirement is so that the nature of the non-financial assets must lend itself to the production of fixed income-like cash flows in order to meet the definition of a bond. Reliance on the residual value of non-cash producing assets to either sell or refinance to service the debt, is reflective of valuation or equity risk of the underlying assets, not bond risk.

Current Status and Next Steps
As initially noted, the Statutory Accounting Principles (E) Working Group, and key industry representatives, have been working dedicatedly on this project since 2020. Significant progress has been achieved with the development and exposure of the Principles-Based Bond Definition and an Issue Paper documenting discussion and rationale. The most recent exposure ended May 6 and a conference call is scheduled July 18 to consider comments received. Although additional comments will continue to be considered as the principles are incorporated into the SSAPs, key individuals involved in the project believe that the main principles are substantially set. The following actions are expected July 18, as part of the call, or shortly thereafter at the Summer National Meeting:

- Exposure of proposed reporting concepts to significantly revise Schedule D-1 to improve the granularity of investment reporting and improve the transparency to regulators of the investments held by reporting entities. The proposed concepts include adding a new schedule to separately capture issuer credit obligations and asset-backed securities, with several new reporting lines to separate investments based on underlying characteristics. (Exposure consideration occurred July 18.)

- Exposure of statutory accounting revisions to reflect the principles-based bond definition in SSAP No. 26R and SSAP No. 43R. These SSAPs are proposed to be significantly revised so that investments that qualify as issuer credit obligations are captured in SSAP No. 26R and investments that qualify as asset-backed securities are captured in SSAP No. 43R. (The existing SSAPs will be renamed accordingly.) (This exposure is anticipated at the Summer National Meeting.)

- Re-exposure of the principles-based bond definition and issue paper to reflect any revisions directed from the July 18 conference call. (This exposure is anticipated at the Summer National Meeting.)

Additional revisions to statutory accounting to provide accounting and reporting guidance for items that no longer qualify for Schedule D-1 reporting are anticipated to be assessed in early fall with exposure later in 2022.

Potential Effective Date: A key question often received is when the guidance will be effective. The earliest the guidance could be effective (with both accounting and reporting revisions in place) would be Jan. 1, 2024. This would require that the reporting revisions are adopted in May 2023. As that deadline is quickly approaching, it is likely that the revisions will be effective Jan. 1, 2025.

Questions on the principles-based bond definition and related reporting revisions can be directed to Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group or Kevin Clark, Vice-Chair of the Statutory Accounting Principles (E) Working Group.