Draft date: 7/2/24

Virtual Meeting

FINANCIAL ANALYSIS SOLVENCY TOOLS (E) WORKING GROUP
Tuesday, July 16, 2024
11:00 a.m. – 12:00 p.m. ET / 10:00 – 11:00 a.m. CT / 9:00 – 10:00 a.m. MT / 8:00 – 9:00 a.m. PT

ROLL CALL

Greg Chew, Chair	Virginia	Judy Weaver/Kristin Hynes	Michigan
Amy Garcia, Vice Chair	Texas	Debbie Doggett	Missouri
Richard Russell/Todrick Burks	Alabama	Pat Gosselin	New Hampshire
Dave Lathrop/Kurt Regner	Arizona	Olga Dixon	New Jersey
Michelle Lo	California	Victor Agbu	New York
Jack Broccoli	Connecticut	Dwight Radel/Tim Biler	Ohio
N. Kevin Brown	District of Columbia	Ryan Keeling	Oregon
Carolyn Morgan/Nicole Crockett	Florida	Liz Ammerman/Ted Hurley	Rhode Island
Amanda Denton	Indiana	Kristin Forsberg	Wisconsin
Lynn Beckner	Maryland		

NAIC Support Staff: Rodney Good/Bill Rivers/Ralph Villegas

AGENDA

1. Consider Adoption of *Financial Analysis Handbook* Guidance Related to Affiliated Investment Management Services and Agreements Referred by the Risk-Focused Surveillance (E) Working Group—*Greg Chew (VA)* — Attachment 1

2. Consider Exposure of Draft *Financial Analysis Handbook* Guidance —*Greg Chew (VA)*
   A. Form A and Disclaimer of Affiliation Applications Referred by the Group Solvency Issues (E) Working Group — Attachment 2
   B. Property and Casualty Insurers Catastrophe Reinsurance Program — Attachment 3
   C. Own Risk and Solvency Assessment Guidance Related to Form F — Attachment 4

3. Consider Exposure of Draft Sample Revisions to the *Financial Analysis Handbook* Branded Risk Repositories—*Greg Chew (VA)* — Attachment 5

4. Receive a Referral from the Risk-Focused Surveillance (E) Working Group Regarding Surplus Notes and Capital Maintenance Agreements —*Greg Chew (VA)* — Attachment 6

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5. Receive a Referral from the Financial Analysis (E) Working Group Regarding Pricing/Underwriting Risks of Health Insurers—*Greg Chew (VA)* — Attachment 7

6. Discuss Any Other Matters Brought Before the Working Group —*Greg Chew (VA)*

7. Adjournment

MEMORANDUM

TO: Greg Chew (VA), Chair, Financial Analysis Solvency Tools (E) Working Group

FROM: Amy Malm, Chair, Risk-Focused Surveillance (E) Working Group

DATE: May 30, 2024

RE: Affiliated Services Guidance

In late 2022, the Risk-Focused Surveillance (E) Working Group received a referral from the Macroprudential (E) Working Group recommending updates to NAIC handbooks (Examiners and Financial Analysis) to provide more guidance to regulators on reviewing affiliated investment management services and agreements. The referral was part of a broader initiative to address a list of "Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers." Because the issue was important for both financial analyst reviews of Form D filings and the subsequent review of affiliated investment services during financial exams, the topic was referred to the Risk-Focused Surveillance (E) Working Group so that guidance could be developed together for both functions.

After a development period that included drafting group work, presentation of the proposed guidance at an in-person meeting, public exposure, and a call to review and finalize an updated draft, the Risk-Focused Surveillance (E) Working Group finalized updated drafts of proposed revisions to the NAIC's *Financial Analysis Handbook* (FAH) and *Financial Condition Examiners Handbook* (FCEH). The proposed edits to the FAH are provided in **Attachment One** of this memorandum.

The proposed revisions have been thoroughly reviewed and subjected to a public comment period and staff recommends they be considered for adoption by the Financial Analysis Solvency Tools (E) Working Group without additional public exposure or significant modifications. This will ensure the guidance remains consistent with the revisions proposed for the FCEH.

If there are any questions regarding the proposed recommendations, please contact us or NAIC staff (Bruce Jenson at *bjenson@naic.org*) for clarification. Thank you for your consideration.

Attachment One

Note: This document includes excerpts from the NAIC's *Financial Analysis Handbook* to which revisions are being proposed to update guidance around the review of affiliated investment management services and agreements. The proposed revisions are shown as tracked changes throughout.

Analysis 1 – III.B.1.b Credit Risk Repository – Life/A&H/Fraternal Annual

Note: To conserve space, similar guidance currently included in the Credit, Liquidity, Market and Operational Risk Repositories for all statement types has not been included in this file.

Credit Risk: Amounts actually collected or collectible are less than those contractually due or payments are not remitted on a timely basis.

Note: The repository is not an all-inclusive list of possible procedures. Therefore, risks identified for which no procedure is available should be analyzed by the state insurance department based on the nature and scope of the risk. Also, note that key insurance operations or lines of business, for example, may have related risks addressed in different repositories. Therefore, the analyst may need to review other repositories in conjunction with credit risk. For example:

- Investment strategy is also discussed in the Liquidity, Market, and Strategic Risk Repository.
- Investment asset classes (Bonds, Mortgages, etc.) also are discussed in Market and/or Liquidity Risk Repositories.
- Reinsurance also is discussed in the Operations and Strategic Risk Repositories.

Analysis Documentation: Results of credit risk analysis should be documented in Section III: Risk Assessment of the insurer.

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Additional Analysis and Follow-up Procedures
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NAIC Capital Market's Bureau Analytical Assistance: Consider requesting the following analytical reviews: • Review of the insurer's investment portfolio. • Review of Investment Management Agreements.
Third-Party Investment Advisers: Assess and determine if any concerns exist regarding third party investment advisers and associated contractual arrangements.

- Review Annual Financial Statement, General Interrogatories, Part 1, #29.05. Does the insurer utilize third party investment advisors, broker/dealer or individuals acting on behalf of the insurer with access to their investment accounts?

If "yes", consider the following procedures:

- Verify that all affiliated and unaffiliated investment advisors the analyst is aware of are disclosed in the interrogatory, whether primary or sub-advisors.
  - Verify that Investment Management Agreements required to be filed with the department have been filed and consider requesting copies of agreements that have not been filed with the department for review.
  - Gain an understanding of the types of investments that are being managed by each of the advisors/sub-advisors disclosed in the interrogatory.

- Review the results of the most recent financial examination work papers, follow-up and prospective risk information and the summary review memorandum provided by the examiners. Did the examination identify any issues with regard to investment advisers and associated contractual arrangements that require follow-up analysis or communication with the insurer? If "yes", document the follow-up work performed.

- Compare Annual Financial Statement, General Interrogatories, Part 1, #29.05 for the current year to the prior year to determine if there have been any changes in advisors. If yes,

  - Consider obtaining an explanation for the change from the insurer.

  - Consider obtaining a copy of the new investment advisor agreement and review it for appropriate provisions.

- Using the information reported in Annual Financial Statement, General Interrogatories, Part 1, #29.05, obtain and review SEC Form ADV (if available), to determine if the investment advisor is in good standing with the SEC. If not in good standing, contact the insurer to request an explanation.
- If agreements with third party investment advisers are affiliated, have the appropriate Form D – Prior Notice of Transactions been filed and approved by the department? Were any concerns noted or follow-up monitoring recommended?

  - See additional guidance in V. C. Domestic and/or Non-Lead State Analysis – Form D Procedures for reviewing affiliated investment manager agreements.

- Request information from the insurer regarding the background and expertise in any complex or non-traditional assets (such as structured securities, mortgage loans, investment funds) of its investment advisors (in-house and/or contractual) and its analytical system capabilities. Determine whether the advisors and systems are adequate to allow the insurer to continuously monitor its ~~structured securities~~ investments.

- If the insurer uses an external asset manager, consider if there are any investments that may represent a potential for conflict. Examples of this are (1) if there are Investments Report on Schedule BA that are ~~invested in~~ funds that are affiliated/related with the asset manager or are managed by that asset manager, (2) Structured Securities in which the asset manager or an affiliate/related party had a role in originating, or (3) direct investments in the asset manager or any of its affiliates/related parties. If the external asset manager qualifies as a related party, utilize guidance provided in the "Related Party

Exposure in the Investment Portfolio" section above to assist in this review. Consider the following issues:

- ~~If any conflicts of interest exist~~Have any potential conflicts of interest been reviewed and formally approved by the Board or Investment Committee.
- If the investment is appropriate for the insurer's portfolio and is arm's-length.
- If the insurer is paying ~~double~~ overlapping fees.

Analysis 2 – III.B.1.d Credit Risk Repository – Analyst Reference Guide

Note: To conserve space, similar guidance currently included in the Credit, Liquidity, Market and Operational Analyst Reference Guides has not been included in this file.

Credit Risk Assessment

Credit Risk: Amounts actually collected or collectible are less than those contractually due or payments are not remitted on a timely basis.

The objective of Credit Risk Assessment analysis is focused primarily on exposure to credit risk of investments and reinsurance receivables. The following discussion of procedures provides suggested data, benchmarks and procedures analysts can consider in their review. In analyzing credit risk, analysts may analyze specific types of investments and receivables held by insurers. Analysts' risk-focused assessment of credit risk should take into consideration the following areas (but not be limited to):

- Concentrations of investments (i.e., diversification)
- Materiality of high-risk or low-quality investments
- Extensive use of reinsurance
- Credit quality of reinsurers
- Collectability of reinsurance receivables
- Collectability of other receivables
- Credit quality of affiliates
- Quality of collateral
- Strategies for mitigating credit risk (i.e., counterparty risk with derivatives and off-balance sheet transactions)
- Uncollected premium and agents' balances

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Additional Analysis and Follow-Up Procedures

INVESTMENT STRATEGY directs analysts to consider requesting and reviewing a copy of the insurer's formal adopted investment plan. This should be evaluated to determine if the plan appears to result in investments that are appropriate for the insurer, based on the types of business written and its liquidity and cash flow needs and to determine whether the insurer appears to be adhering to its plan. For example, the insurer's plan for investing in non-investment grade bonds should be reviewed for guidelines for the quality of issues invested in and diversification standards pertaining to issuer, industry, duration, liquidity, and geographic location.

EXAMINATION FINDINGS direct analsyts to consider a review of the recent examination report, summary review memorandum and communication with the examination staff to identify if any credit risk issues were discovered during the examination.

NAIC CAPITAL MARKETS BUREAU ANALYTICAL ASSISTANCE directs analysts to consider requesting the NAIC's Capital Markets Bureau (CMB) to assist with investment portfolio or investment management agreement analysis. The CMB has different levels of analysis that can be arranged to assist the state.

THIRD-PARTY INVESTMENT ADVISORS assist analysts in determining whether concerns exist regarding the use of third-party investment advisers. As investments and investment strategies grow in complexity, insurers may consider the use of unaffiliated third-party investment advisers to manage their investment strategy. Investment advisers may operate independently or as part of an investment company. Investment advisers and companies are subject to regulation by the U.S. Securities and Exchange Commission (SEC) and/or by the states in which they operate, generally based on the size of their business. In certain situations, insurers may use a broker-dealer for investment advice. Broker-dealers are subject to regulation by the Financial Industry Regulatory Authority (FINRA). Regardless, most broker dealers and investment advisers will register with the SEC and annually update a Form ADV–Uniform Application for Investment Adviser Registration and Report Form by Exempt Reporting Advisers, which provides extensive information about the nature of the organization's operations. To locate these forms, analysts can go to *https://adviserinfo.sec.gov* and perform a search based on the company name.

Key information provided on a Form ADV includes:

a. Regulatory agencies and states in which the adviser/broker is registered

b. Information about the advisory business including size of operations and types of customers (Item 5)

c. Information about whether the company provides custodial services (Item 9)

d. Information about disciplinary action and/or criminal records (Item 11)

e. A report of the independent public accountant verifying compliance if the investment advisor also acts as a custodian

It is important to note that the information provided on Form ADV is self-reported and is subject to limited regulatory oversight. However, the information may be valuable to analysts in assessing the suitability and capability of investment advisers providing advisory services to insurers. In addition, although not expressly prohibited (as discussed at e. above), it is a best practice for the insurer to choose a national bank, state bank, trust company or broker/dealer which participates in a clearing corporation, other than its investment manager/advisor, to hold its assets in custody to promote segregation of duties. See additional guidance on custodial expectations in Section 1.F – Outsourcing of Critical Functions of the NAIC's Financial Condition Examiners Handbook.

Analysts should consider any significant risks identified in the most recent risk-focused examination and whether any follow-up procedures were recommended by the examiner. The examiner may have performed steps to determine the following: whether the investment adviser is suitable for the role (including whether he/she is registered and in good standing with the SEC and/or state securities regulators); whether the investment advisory agreements contain appropriate provisions; whether the adviser is acting in accordance with the agreement; and whether management/board oversight of the investment adviser is sufficient for the relationships in place.

Analysts should determine if changes have occurred in the insurer's use of investment advisers that may prospectively impact the insurer's investment strategy and overall management of the investment portfolio. If changes have occurred analysts may consider asking the insurer for an explanation for the change in investment advisers and obtain a copy of the new adviser agreement to gain an understanding of the provisions including the advisor's authority, specific reference to compliance with the insurer's investment strategy and/or policy statements, as well as state investment laws; conflicts of interest; fiduciary responsibilities; fees; and the insurer's review of the adviser's performance. ~~(~~Refer to the *Financial Condition Examiners Handbook* for further guidance and see V. C. Domestic and/or Non-Lead State Analysis – Form D Procedures for additional guidance on reviewing affiliated investment management agreements.~~)~~

Analysts can determine if the investment advisor is in good standing with the SEC. The SEC does not officially use the term "good standing"; however, for this analysis, the term is used to mean a firm that is registered as an investment adviser with the SEC and does not report disciplinary actions or criminal records in Item 11 of the Form ADV.

If the insurer uses an external asset manager and if investments on Schedule BA assets are invested in funds that are affiliated with the asset manager or are managed by that asset manager, analysts should consider several possible issues that may result from this scenario. A possible concern may exist when the asset manager is also managing other funds in addition to managing assets for the insurer and then invests the insurer's assets in those other funds that the asset manager manages. While those funds may be good investments, both in general and for the insurer, there are a few issues that may need to be considered. First is the potential for a conflict of interest if the asset manager is using the insurer's available funds to provide seed money or fund the manager's other funds. Second is if any concerns exist regarding the appropriateness of the fund for the insurer's investment portfolio and if the transactions would be considered on an arm's-length basis. Third is the understanding that the insurer may be paying ~~double~~ overlapping fees as the insurer would pay the asset manager a fee for the investment and then also pay a fee within the fund investment. There may be similar concerns with other complex investments such as structured securities that are originated by the asset manager or one of its affiliates/related parties. The fees associated with these investments could be considered arms-length and appropriate but would require further review and potentially additional support or documentation to make that determination.

Analysis 3 – V. C. Domestic and/or Non-Lead State Analysis – Form D Procedures

Special Notes:

The following procedures do not supersede state regulation but are merely additional guidance analysts may consider useful only if the state has adopted the *Insurance Holding Company System Model Regulation with Reporting Forms and Instructions*, (#450).

Form D – Prior Notice of a Transaction

Form D is transaction specific and is not part of the regular annual/quarterly analysis process. The review of these transactions may vary as some states may have regulations that differ for Form D.

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Assessment of Form D – Prior Notice of a Transaction

14. Review Form D for any significant and/or unusual items or inconsistencies. Determine if the transaction is fair and reasonable as required under Section 5A(1)(a) of Model #440 by considering the following:
    a. For reinsurance agreements, are the general terms, settlement provision, and pricing consistent with those of agreements with non-affiliates?
    b. For management, service or cost-sharing agreement, are the charges or fees to be paid by/to the insurer reasonable in relation to the cost of such services?
    c. Are fees paid for related party transactions consistent with the applicable section of the state's Insurance Holding Company Act? (Note: Insurers should not use related-party transactions as a method for transferring profits of the insurance company to an affiliate or related party.)
    d. Will the insurer have adequate surplus upon completion of the transaction?
    e. Does the transaction comply with the NAIC AP&P Manual? Are expenses incurred and payment received allocated to the insurer in conformity with prescribed insurance accounting practices consistently applied?
    f. Are books, accounts and records of each party maintained clearly and accurately to disclose the nature and details of the transactions including such information as is necessary to support the reasonableness of charges or fees to the respective parties?
    g. Does the transaction comply with the state's requirements regarding the insurer's ownership of data and records that are held by an affiliate, and control of premium or other funds belonging to the insurer that are collected or held by an affiliate?[1]

[1] Procedure 16.g represents amendments to Insurance Holding Company System Model Act (Model #440) Section 5A(1)(h) and 5A(1)(i) as adopted by the NAIC on Aug. 17, 2021. As state insurance departments are still in the process of adopting these amendments into state law, analysts should refer to their own state's holding company law or regulation regarding compliance with Form D filings of management, service and cost-sharing agreements

h. Do unusual circumstances, risks or concerns exist?

i. Any other state-specific requirements for determining and reviewing fair and reasonableness.

15. Determine whether the transaction was accounted for properly, based on statutory accounting principles, with the NAIC AP&P Manual.

16. In evaluating fairness and reasonableness of affiliated investment management agreements, consider whether the following elements are appropriately included in the agreement:

a. **Selection of Investments** – It should be clear from the advisory agreement how the investment adviser will select investments. This should be detailed through clear investment guidelines documented in the investment management agreement, which are also in compliance with the insurer's investment strategy and applicable laws and regulations.

b. **Authority for Transactions** – Advisory agreements should address the level of authority that will be given to the investment adviser in executing transactions.

c. **Conflicts of Interest** – To the extent that any conflicts of interest may be known to the insurer, the advisory agreement should specifically indicate the manner in which such conflicts will be considered.

d. **Fiduciary Responsibility** – Language provided in the investment management agreement should acknowledge the investment adviser's role as a fiduciary in advising the insurer and, if applicable, confirm the entity's registration as an investment advisor/manager with the SEC and/or State securities regulators.

e. **Calculation of Fees** – It is important that the manner in which fees are calculated is well defined in the management agreement and that the structure of the fee is considered as management assesses the adviser's performance. Special attention should be paid to whether there are any performance or incentive fees over and above a base management fee.

f. **Sub-Advisors** – Does the investment manager have the authority to engage sub-advisors and is consent by the insurer required? Who is responsible for the fees of the sub-advisor?

g. **Reporting** – Are expectations for the reporting of portfolio performance included in the agreement?

h. **Termination** – Are there appropriate termination provisions, both with and without cause?

i. **Review of Performance and Compliance** – Agreements should include consideration of information that will be provided to the company to permit the company to perform adequate review of the adviser's performance and execution of the investment strategy, including compliance with adopted investment guidelines.

Analysis 4 – V.F. Domestic and/or Non-Lead State Analysis – Analyst Reference Guide

Non-Lead State Holding Company System Analysis Procedures

Refer to section VI.C. Group-wide Supervision - Insurance Holding Company System Analysis Guidance (Lead State) for additional guidance on holding company analysis procedures.

Forms A, B, D, E (or Other Required Information), and Extraordinary Dividend/ Distribution

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Form D – Prior Notice of a Transaction

PROCEDURES #1-18~~6~~ assist analysts in reviewing the Form D filing for completeness and help guide analysts through major items of information required by Form D.

Best Practices for Agreements with Affiliates for Management and Services

Charges for Fees for Services

SSAPs 25 and 70 and Appendix A-440 discuss the Transactions Involving Services, Allocation of Costs, and Other Management Requirements.

Pricing for agreements with affiliates may be negotiated between related parties on a variety of basis including cost and other than cost-based pricing. Regardless of the method utilized, it is the responsibility of management to appropriately evidence that the terms of the agreement satisfy the “fair and reasonable” standard. It is management’s responsibility to provide documentation demonstrating that this standard has been met using any of a number of methods including but not limited to those described below. The Form D filing should thus include management’s documented support for its assertion that the transaction meets the “fair and reasonable” standard.

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Regulator Considerations

Items for initial filing review—the actual document(s) should be filed, not merely a summary (these apply regardless of the method – cost or other than cost – unless otherwise noted):

- Identify and document:
  - The specific services that will be provided
    - The specific expenses and/or costs that are to be covered by each party (cost)
  - The entity(ies) providing and receiving each of those services

        - Separate affiliate entities from non-affiliates
    - Allocation method (cost or other than cost) of the agreement
        - The charges or fees for the services indicated
    - The accounting basis used to apportion expenses (cost)
    - Confirm that contract provisions will be accounted for in accordance with SSAPs
    - Invoicing and settlement terms (should allow for admittance under SSAP 96)
    - The effective date and termination date
    - The records rights and policies of each entity that is a party in the contract
    - The governing law
    - Any unique and relevant clauses not covered above
    - Financial statements of the entity providing the services
- Other Considerations for Review of the Agreement:
    - Determine the reasonableness of the allocation method and the charges or fees, considering such items highlighted in the “Transactions at Cost” and “Transactions at Other than Cost” sections above
    - Assess if cash flows/activities relating to the agreement are in line with forecasted amounts provided in the initial Form D review and, if not, inquire about material or unexpected variations, their cause, and implications
    - Consider if there have been significant changes in the market for the services subject to the agreement, whether management has considered them and, if so, whether changes to the agreement have been made or are anticipated (for other than cost-based agreements)
    - Inquire of management if the agreement continues to be fair and reasonable and their supporting rationale and whether it has changed since the initial filing
    - Consider the insurer’s aggregate exposure to all agreements with affiliates, current and trending, both in terms of absolute dollars as well as relative to a base (e.g., capital and surplus; total expenses, etc.)
    - Does the agreement trigger or increase related party transaction or financial /solvency concerns
    - Determine the agreement does not divert funds that could be considered a dividend
    - Determine the agreement does not result in the insurer’s fair share of expenses being retained by or allocated to a parent/affiliate, thereby masking the true performance of insurance operations
    - Summarize the business rationale for purpose and need of the agreement
    - Summarize the financial impact of the agreement on the company’s surplus or financial condition
    - Summarize the impact the agreement would have on the priority status of the company
    - Summarize the reasons to approve/disapprove the agreement

Additional Considerations for Affiliated Investment Management Agreements:

In addition to regulator considerations for filing review listed above, the following considerations are included to provide additional guidance for a review of affiliated investment management agreements. A critical consideration in assessing whether the terms of an affiliated investment management agreement are fair and reasonable is to assess the level of oversight provided to the affiliated asset manager, as outlined through the following criteria:

- **Selection of Investments** – The insurer should provide guidance to its affiliated asset manager on investment selection by providing clear investment guidelines that are documented in the investment management agreement at a sufficient level of detail on (a) what are permitted investment types, (b) limitations and restrictions on exposures, (c) specific risk metrics (e.g., credit quality and duration). These guidelines should reflect the type of assets that the asset manager has experience in. The guidelines for unaffiliated asset managers are often more limiting than the insurer's investment guidelines but it is not uncommon that may be the same in the case of an affiliated asset manager given the nature of that relationship. Nonetheless this should be a separate and distinct document.
- **Authority for Transactions** – The investment management agreement should describe the level of discretion that the affiliated asset manager has, as opposed to transactions that require prior approval from the insurer. Total discretion for the affiliated asset manager may not be appropriate for investments that are very complex, illiquid or large exposures. It may be desirable in those situations for the insurer's investment committee to retain authority.
- **Conflicts of Interest** – This is an important protection against an investment adviser's biases due to business arrangements (e.g., referral relationships, affiliate product offerings, etc.) that may interfere with the proper execution of the investment strategy. For example, investment advisers often have affiliates that offer investment options that should be available to the insurer but should not be given preferential treatment if competitor products are determined to be a better fit for the selected investment strategy. This is somewhat less critical for affiliated asset managers, but it is still advisable to have appropriate recognition of the potential for concerns, especially when the affiliated asset manager may also have third party clients. The typical areas of focus are transactions such as cross trades (those not involving a broker) and investments that may be considered related party transactions. This goes in conjunction with the acknowledgement that the affiliated asset manager is acting in a fiduciary capacity.
- **Fiduciary Responsibility** – Asset managers, whether or not they are formally registered as such, are still subject to the Investment Advisers Act of 1940. As such it is critical that all asset managers, whether affiliated or unaffiliated, acknowledge that the standard of care is that of a fiduciary. The affiliated investment manager is a separate legal entity from the insurer and this recognition provides for a standard of care that is equivalent. This is an important legal distinction that may help protect the insurer's interests in the execution of the company's investment strategy. The fiduciary standard is generally implied when an asset manager is registered as an investment advisor, which may be required at the federal (SEC) or state level (state securities regulator) depending on the nature and extent of services provided. In reviewing an affiliated Investment Management Agreement, the department should consider confirming whether the advisor is formally registered in accordance with existing legal requirements and in good standing

with its securities regulators. If the advisor asserts that it is exempt from registration requirements, the department should consider verifying that the advisor continues to meet the exemption criteria.

- **Calculation of Fees** – Management fees should reflect the current market conditions and should reflect the kind of assets and type of asset management. More complex investments and investment strategies do warrant higher management fees. Management fees for more plain vanilla assets have declined significantly over the last few years. While not common, different kinds of performance or incentive fees may be included. If so, it is important that the language be extremely clear when such payments are due so that the calculation can be verified. In the case of affiliated asset managers, special attention should be paid to the total amounts paid by the insurer to guard against such fees becoming a way around dividend restrictions. For example, if the advisory fee is computed based on volume of transactions, it would be important for management to closely review the frequency of trades to help avoid excessive charges.
- **Sub-Advisors** – The insurer should retain the right to consent to any sub-advisors as well as the ability to cancel such an arrangement. It should also be clear who is responsible for paying the management fees of the sub-advisor. Either the sub-advisor's fees should be paid by the primary asset manager, or if paid by the insurer, the assets managed by the sub-advisor should not be included in the calculation for the primary manager. The affiliated asset manager may make the argument that they are overseeing the activities of the sub-advisors. Oversight is much less resource intensive and does not warrant a significant fee, even if permitted.
- **Reporting** – When the asset manager is affiliated, this is also less of a concern. Nonetheless some clear language on responsibility is advisable. This should include at least quarterly, if not monthly, reporting of the portfolio including different risk metrics.
- **Termination** – The agreement should include clear termination provisions that allow for a timely transition of investment management services and protect the rights of the insurer upon termination of the agreement.
- **Review of Performance and Compliance** – Following on some of the points above, proper governance still requires regular performance review and tracking of compliance with investment guidelines.

The insurer should still maintain an adequate control framework over investments, including monitoring and managing transactions, and monitoring compliance by the affiliate. They should not rely solely on the affiliated investment manager for oversight in this area.

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

To: Greg Chew, Chair of Financial Analysis Solvency Tools (E) Working Group

From: Jamie Walker, Chair of Group Solvency Issues (E) Working Group

Date: Nov. 20, 2023

Re: Referral on Guidance for Regulatory Review of Form A and Disclaimer of Affiliation Applications

In July 2022, the NAIC Macroprudential (E) Working Group (MWG) of the Financial Stability (E) Task Force (FSTF) sent a referral to the Group Solvency Issues (E) Working Group (GSIWG) concerning NAIC activities to develop regulatory considerations and guidance related to complex ownership structures.

The MWG's considerations that were referred to GSIWG are listed as follows. For reference, the 2022 referral to GSIWG including additional details is included as **Attachment A**.

MWG Consideration Items Referred to GSIWG:

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).*
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.*

The GSIWG formed a drafting group to review these two MWG considerations against the existing regulatory guidance, and to develop proposals to address the MWG's considerations.

In its review of the *Financial Analysis Handbook* the drafting group concluded that the Handbook includes substantial guidance regarding the review of Form A and the review of business plans in annual risk-focused solvency surveillance. However, it identified some areas where additional guidance or clarity in the Handbook may be appropriate, specifically the review of disclaimers of affiliation.

The GSIWG recommends the FASTWG consider the draft guidance provided in **Attachment B** for public exposure and adoption into the Handbook.

If you have any questions, please contact NAIC Staff, Jane Koenigsman (jkoenigsman@naic.org).

Special Notes: The following procedures do not supersede state regulation but are merely additional guidance analysts may consider useful. The procedures may be completed in part, or in total, at the discretion of the analysts depending on the level of concern, and the area in which the risk was identified.

Form A – Statement of Acquisition of Control of or Merger with a Domestic Insurer

Model Act and Database Procedures

Form A is transaction-specific and is not part of the regular annual/quarterly analysis process. Every Form A review should be tailored to the risks associated with the proposed acquisition, including the target company, acquiring entity, and the complexity of the transaction. The review of these transactions may vary, as some states might have regulations that differ for Form A.

Initial Review

1. Determine if the filing is complete, note the missing items and promptly send a deficiency letter to the Applicant. A filing may not be considered complete and active until all relevant information has been received. Enter any changes to the status of the filing or other data elements into the NAIC Form A database within 10 days of receipt of the Form A. Data and information should be entered by the state's designated person.
    a. Identify attorneys, party contacts (all stakeholders), and other insurance regulators reviewing the Form A, including the lead regulator.
    b. Assign appropriate analyst, legal, and other professional staff to conduct regulatory review.
    c. Carefully consider whether regulatory review can be completed by Applicant's target close date, including any interim deadlines and obtain deemer extension or waiver if appropriate.
    d. Schedule and notice hearing/consolidated hearing, if applicable, within statutory timeframes.
    e. Review the NAIC Form A database to determine whether the current Form A is pending or has been approved, denied, or withdrawn in another state. Assess any reasons noted for denial and document any risks or concerns.

2. Establish contacts with other states and regulators to discuss the status and/or disposition of the current and prior filings made with those states. Where multiple jurisdictions are involved, coordination of information between the states and functional regulators should be initiated by the lead states(s). Perform the following steps:
    a. The domestic state should notify the lead state regulator of the holding company group of any merger or acquisition of a domestic insurer in the group.
    b. The lead regulator should obtain key contact information from each state reviewing the Form A and consider organizing a regulator to regulator call to discuss concerns with the filing.
    c. Create a contact list of relevant persons and representatives.
    d. Separate confidential and public documents, information, and communications and maintain as appropriate.
    e. Contact and collaborate with other reviewing regulators involved in the review process, as appropriate, including the lead state regulator regarding ORSA and ERM reviews.
    f. As applicable, contact other regulators of noninsurance entities of the acquiring party or target.
    g. Based on the nature and materiality of the transaction, the lead state and domestic state(s) should regularly communicate with all states and other functional regulators, as necessary throughout the filing

review process, to provide updates on the transaction, states' reviews, and to share feedback between regulators.

h. Where multi jurisdictions are involved and based on the size and complexity of the acquisition/merger, the lead state should take responsibility for the coordination and facilitation of communication. Regulators should work jointly on the Form A review to maximize efficiency and promote coordinated communications with the insurers involved to reduce duplication of regulatory efforts, where possible.

Compliance Assessment and Review

Transaction Details

3. Review details provided on the transaction for compliance with application filing requirements by determining whether the Form A application provides the required content, which may include the following:

   a. Provides a brief description of how control is to be acquired.

   b. Contains the following information:

      - Name and address (legal residence for an individual or street address if not an individual) of the applicant
      - States the nature of the applicant's business operations for the past five years, if the applicant is not an individual
      - Describes the business to be performed by the applicant and its subsidiaries
      - Identifies and states the relationship of every member of the insurance holding company system on the organizational chart

   c. Contains the required signature and certification, and include copies of all tender offers for, requests or invitations for, tenders of, exchange offers for, and agreements to acquire or exchange any voting securities of the insurer and of additional soliciting material relating thereto.

   d. Contains any proposed employment, consultation, advisory or management contracts concerning the insurer, annual reports to the stockholders of the insurer and the applicant for the last two fiscal years, and any additional documents or papers required by the Form A.

   e. Contains an agreement to provide the information required by Form F – Enterprise Risk Report within the required timeframe.

   f. Includes the number of each class of shares of the insurer's voting securities that the applicant, its affiliates, and any person that plans to acquire; 2) the terms of the offer, request, invitation, agreement, or acquisition; and 3) the method by which the fairness of the proposal was determined.

   g. States the amount of each class of any voting security of the insurer that is beneficially owned or concerning that there is a right to acquire beneficial ownership by the applicant, its affiliates, or any person.

   h. Gives a full description of any contracts, arrangements, or understandings with respect to any voting security of the insurer in which the applicant, its affiliates, or any person is involved. Discussion includes, but is not limited to, the transfer of any of the securities, joint ventures, loan or option agreements, puts or calls, guarantees of loans, guarantees against loss or guarantees of profits, division of losses or profits, or the giving or withholding of proxies.

4. Perform analysis review considerations, in addition to the compliance review in #3 as necessary, to analyze the details of the transaction, which may include, but is not limited to the following:

a. Document any risks or concerns by carefully reviewing transactional documents (e.g., merger, stock purchase, stock exchange).

    i. Consider disposition of all classes of target shares, including addressment of any beneficial owners.

    ii. Ascertain propriety of disposition of minority interests and concerns, if applicable.

b. Consider any affiliate or employee benefit as appropriate.

c. Has the applicant included information on the assignment of specialized personnel (such as an attorney, actuary, or CPA) to the transaction?

d. Determine how any ancillary regulatory reviews or other interim procedural steps will be completed, including Form E – Pre-Acquisition Notification Form, for other licensed states.

e. Obtain copies of shareholder communications or sole shareholder consent.

f. Consider obtaining copies of fairness and other contractually required opinions, if available.

g. Review relevant portions of board resolutions, power points and related board minutes pertinent to the Form A transaction, using care to keep documents confidential.

h. Determine if after the change of control:

    i. The insurer will be able to satisfy the requirements for the issuance of a license to write the classes of insurance for which it is presently licensed.

    ii. The insurer's surplus will be reasonable in relation to its outstanding liabilities and adequate for its financial needs.

i. Review financial projections for the applicant and the insurer to ensure that they are consistent with the description of the intended business plan of the insurer and other assertions and representations made in the Form A filing. Determine whether the projections are based on reasonable expectations.

    i. Determine the target's estimated post-acquisition financial condition and stability.

j. If not included in the Form A filing, request copies of all contracts between the applicant (or other entities for which it exhibits control) and the insurer. Review these contracts to ensure that the terms are at arm's-length, fair, and reasonable to the insurer.

k. Will the proposed merger or acquisition comply with the various provisions of the state's General Administrative Amendments or Business Corporation Law (e.g., board resolutions, plans of merger, draft articles of merger, etc.)?

l. Does the Form A describe any plans or proposals for which the applicant might have to declare an extraordinary dividend, to liquidate the insurer, to enter into material agreements (including affiliated agreements), to sell the insurer's assets, to merge the insurer with any person or persons, or to make any other material change in the insurer's business operations, corporate structure, or management?

m. Consider suitability of any new affiliated and non-affiliated material agreements, including managing general agents, third party administrators, any professional organizations and reinsurance arrangements.

n. Consider plans for technological interfacing with new affiliates and any potential adverse impact on operations including claims.

o. Require Form D filings for any affiliated material transactions, post-acquisition; consider including language in the approval order.

p. Consider with disfavor any plans to liquidate the target or sell its assets, consolidate or merge, that may be unfair, unreasonable, or hazardous to policyholders.

q. Review required statutory deposits and authorized lines of business.

r. Has the insurance department identified any reasons or circumstances surrounding the transaction to warrant the hiring of outside experts or consultants?

Ultimate Controlling Person/Parent (UCP), Officers, and Directors

5. To identify the UCP, review the ownership documents/agreements and other information provided in the Form A application to understand its ownership structure, the terms of the documents/agreements, each parties' rights and responsibilities conveyed by the documents/agreements, who has responsibility for decisions and who controls the insurer.

~~5.~~6. Review the background information and financial statements provided in the application for the UCP.

a. Does the Form A summarize the fully audited financial statements regarding the earnings and financial condition of the ultimate controlling party(ies)/person(s) for the preceding five years, and are exhibits and three-year financial projections of the insurer(s) attached to the filing?

i. Identify the Audited Financial Statements (or CPA reviewed financial statements for individuals) of the ultimate controlling party(ies)/person(s).

ii. Review holding company, and the UCP, 10K and 10Qs, and other current financial information for enterprise condition, potential debt service by the UCP and its ability to service such debt.

iii. If fully audited financial information is not available, consider acceptability of unaudited financial statements regarding the earnings and financial condition, compiled personal financial or net worth statements and/or tax returns of the ultimate controlling party(ies)/person(s), as deemed acceptable to the commissioner.

iv. Financial statements accompanied by a certificate of an independent public accountant to the effect that such statements present fairly the financial position of the applicant and the results of its operations.

v. Management's assessment of internal controls accompanied by an independent public accountant's report to the effect that the applicant maintained effective internal controls.

~~6.~~7. Perform additional review considerations as necessary to analyze and identify potential risks concerning the UCP, Officers, and Directors which may include but not limited to the following:

a. Perform a query of the NAIC Form A database on the name of the UCP, directors, executive officers, or owners of 10 percent or more of the voting securities of the applicant and perform the following step(s):

i. Assess the feasibility of the acquiring person's holding company structure including location and control (direct/indirect) of the target company post acquisition.

ii. Carefully scrutinize and understand complex organization and ownership structures.

1. Whether a simple corporate structure, or a unique or complex structure such as trusts, limited partnerships (LP) and limited liability corporations (LLC), review the ownership documents and agreements to understand the terms of the structure, each parties' rights and responsibilities conveyed by the agreement, who has responsibility for decisions and who controls the insurer. For LPs, also identify who has controlling interest in an LP's general partner and who has the right to unilaterally replace the general partner (if anyone). For trusts, also identify who has the ability to modify a trust.

2. For structures with complex or unique share classes and voting carefully review the voting and non-voting share classes rights and agreements to determine who has rights to control and vote to make decisions.

3. Request and review corresponding investment, management or operational agreements as necessary to determine if any delegate control or decision making to another specific person or entity.

b. Review other external sources to gain a better understanding of the acquiring persons, its affiliates, and the UCP.

c. Identify and review all relevant parties to the proposed acquisition and the nature of other filings made in other states by similar individuals.

d. Consider suitability of UCP through background review and regulatory review of the prospective new owners, using UCAA biographical affidavits and third-party background reviews by NAIC listed independent third-party reviewing companies or fingerprinting criminal checks if applicable and note any risks or concerns regarding competence, experience, and integrity of the applicant, as well as the results of any background investigation.

e. Does the Form A provide adequate background information (e.g., biographical affidavits including third-party background checks) on the applicant (if an individual) or all persons who are directors, executive officers, or owners of 10% or more of the voting securities of the applicant (if the applicant is not an individual)?

f. Review the lead state's assessment of the acquiring UCP's most recent ORSA Summary Report and information in the Group Profile Summary (GPS) regarding Form F, if applicable; to better understand the impact on risk assessment, risk appetite and tolerances, and prospective solvency (capital and liquidity).

g. Cross check the UCP with source of funds and consider debt funding sources.

~~g.~~h. Review and assess the UCPs ability to provide future capital support to the insurer, if needed.

i. Consider acceptability of SEC disclosures by board members of publicly traded UCPs in suitability review.

j. Review rating agency reports and public news sources to identify and assess comments or concerns, have been expressed regarding the acquiring entity (or group).

k. For non-U.S. acquiring parties: Carefully evaluate Form A applications and supporting documentation received from non-U.S. acquiring entities to understand its ownership structure and identify the UCP. Consider the following steps:

   i. Carefully consider the impact of varying accounting and auditing standards utilized in other countries when evaluating financial data and results.

   ii. Identify and investigate the nature and extent of government control over or involvement with the acquiring entity.

   iii. Ask the parties involved in the transaction for the results of the Committee on Foreign Investment in the U.S. (CFIUS) review (if applicable).

   iv. Communicate and coordinate with the group-wide supervisor regarding each jurisdiction's review of affiliated entity acquisitions, requesting assistance to verify biographical affidavits and understanding the roles, responsibilities, and expectations for post-acquisition solvency monitoring.

Purchase Consideration

~~7.~~8. Analyze the source, nature, and amount of consideration used (or to be used) in effecting the merger or acquisition of control and assess the ability of the entity to fund the insurance company.

a. Determine fairness (equivalency) of total amount to be paid to total value to be received, including derivation of price and value of target under standard valuation methodologies or to book value.

b. Consider quality of consideration, giving careful scrutiny to payments other than cash or cash equivalents which are disfavored particularly when any funds are being transferred to the target.

c. Consider fairness opinions and actuarial appraisals, if provided.

d. Consider source, type and valuation basis of funds to be used for consideration.

   i. If funds are from a regulated entity, confirm the existence and valuation of such assets with that entity's regulator.

e. Where the applicant issues or assumes debt obligations or is required to fulfill other future obligations as a result of the purchase or through existing agreements, review the holding company's cash flow projections to ensure that cash flows appear adequate to cover such obligations without relying heavily on cash flows from the insurer.

f. Review dividend expectations and projections, including amounts expected to be paid from the insurer to the owner.

   i. Will dividends from the insurer be required to support debt payments of the applicant or the applicant's subsidiaries?

~~8.~~9. If amounts will be borrowed, consider the following:

a. Does the Form A describe the relationship between the borrower and lender, the amounts to be borrowed, and include copies of all agreements, promissory notes, and security arrangements relating thereto?

b. Does the Form A describe the nature, source, and the amount of funds or other consideration (e.g., pledge of stock, other contributions, etc.) used or expected to be used in effecting the merger or acquisition of control?

c. Does the Form A:

   i. Describe any purchases of any voting securities of the insurer by the applicant, its affiliates, or any person during the 12 calendar months preceding the filing of the Form A.

   ii. Describe any recommendations to purchase any voting securities of the insurer made by the applicant, its affiliates, or any person—or by anyone, based on interviews or the suggestion of the applicant, its affiliates or any person—during the 12 calendar months preceding the filing of the Form A.

   iii. Describe the terms of any agreement, contract, or understanding made with any broker-dealer as to solicitation of voting securities of the insurer for tender and the amount of any fees, commissions, or other compensation to be paid to broker-dealers.

d. Perform additional review considerations as necessary to analyze the purchase conditions and implications of any debt financing, which may include, but is not limited to the following:

   i. The mechanics of any debt financing to be used to fund the transaction, whether funds are being borrowed in the ordinary course of business or on terms that are less favorable than generally commercial loans.

   ii. The percentage of debt versus non-debt funds to be used.

   iii. The source of funds or stream of income to be used by parent for repayment and the ability of the acquiring party to repay the debt from sources other than the target.

iv. Identity of the creditor(s) and creditors' financial condition.

v. How will debt be secured; consider prohibiting securing of debt on shares of target or target's assets if not already prohibited by state statute.

vi. Compare time period of loan commitment with parent's income stream over the same time period, including the ability of the acquiring party to repay the debt from sources other than the target until loan is repaid/retired.

vii. Consider the long-term impact of parent's debt service on operations of the target company and group.

viii. Does the Form A explain the criteria used in determining the nature and amount of such consideration?

Market Impact

~~9.~~10. Is the acquisition of control likely to lessen competition substantially or likely to lead to a monopoly in insurance in the state? If "yes," has a Form E been filed?

~~10.~~11. Perform additional review considerations to analyze market impact, which may include, but is not limited to the following:

a. Consider anticompetitive impact of acquisition on lines or products. Disapprove transaction if completion will create a monopoly.

b. Consider Form E information and market concentration for combined lines and other appropriate information to assess market impact if warranted by nature of transaction, including coordination with other states where the target is admitted.

c. Consider imposing tailored conditions subsequent or undertakings as necessary to address competitive market concerns.

Record Maintenance and Conclusion

~~11.~~12. Respond as appropriate to questions from third parties and interested regulators and keep the acquiring party representatives informed as to status of the review.

~~12.~~13. Receive and consider any information provided by external sources, including possible financial or other incentives or motivation of those commenting on a particular transaction.

- File and maintain documents under state procedures

~~13.~~14. Has the application been publicized to all interested persons inside and outside of the insurance department, in accordance with the department's policy or applicable laws?

~~14.~~15. Perform any additional procedures, as deemed relevant, to evaluate the Form A application in accordance with the specific circumstances identified, which may include, but is not limited to, the following:

- Contact the insurer seeking explanations or additional information
- Obtain the insurer's business plan
- Meet with the insurer's management

~~15.~~16. Develop and document an overall summary and conclusion regarding the holding company Form A application.

- If application approval is deemed appropriate, consider whether any conditions precedent, specific ongoing stipulations or conditions subsequent should be included with the approval.

~~16.~~17. Add any material items from the Form A review to the Insurer Profile Summary.

Post-Approval

Post-Approval Considerations (if applicable)

~~17.~~18. Receive notification of changes to effective closing date.

~~18.~~19. Confirm compliance with conditions precedent.

~~19.~~20. Receive waivers for market conduct or financial examination.

~~20.~~21. Receive notification if transaction does not close and consider withdrawal of approval.

Post-Acquisition Considerations

~~21.~~22. Receive confirmation of the transaction following the closing, per your state's statutory requirement timeframe.

~~22.~~23. Request written details of the final purchase price after all adjustments are complete on the transaction.

~~23.~~24. Request confirmation of any capital contribution contemplated in the transaction. Request the names and titles of those individuals who will be responsible for the filing of the amended Insurance Holding Company System Annual Registration Statement.

~~24.~~25. Request an amended Insurance Holding Company System Registration statement per your state's statutory timeframe within each applicable state's statutory required timeframe after the close of the proposed transaction.

~~25.~~26. Consider requesting for a period of two years, commencing six months from closing, a semiannual report under oath of its business operations in your state, including but not limited to, integration process; any changes to the business of the Domestic Insurers; changes to employment levels; changes in offices of the Domestic Insurers; any changes in location of its operations in your state; and notice of any statutory compliance or regulatory actions taken by other state regulatory authorities against the acquiring parties or the Domestic Insurers.

~~26.~~27. Consider prior approval of all dividends for a two-year period from the close date.

~~27.~~28. If concerns are identified during the post-acquisition review, consider the following actions:

- Conduct a target financial and/or market conduct examination
- Hold a meeting, conference call or requesting additional information from the insurer or applicant
- Require additional interim reporting from the insurer
- Obtain a corrective plan from the insurer

Post-Closing Monitoring:

Consider monitoring the following after the close of the acquisition.

~~28.~~29. Confirm ongoing compliance or satisfaction with any other conditions subsequent, ~~or~~ undertakings or other expectation and stipulations that were set as part of the Form A approval.

~~29.~~30. Monitor target's market performance to projections two years after transaction close date.

31. Ongoing commitments and capital support to the insurer from the new owner.

32. Review of subsequent Board minutes.

33. Specific to an international acquisition:
    a. Monitor the Board and the International UCP's involvement and influence over the U.S. operations
    b. Assess the implementation of how the U.S. business is incorporated into or decentralized from the non-U.S. operations
    c. Access to the Group ORSA (as opposed to the US ORSA)
    d. Actively participating in supervisory colleges and other international coordination efforts to evaluate the solvency position of the acquiring entity/group as appropriate.

34. Monitor the ongoing financial condition of the acquiring entity/group by:
    a. Comparing actual results to pre-transaction projections to determine whether results of the acquisition/merger are meeting expectations. If not, gain an understanding of why projections have not been achieved and the company's planned actions to address issues.
    b. Requesting and reviewing information on the integration of company processes and systems (if applicable), as well as steps taken to ensure that adequate cybersecurity precautions are taken during the integration process.
    c. Reviewing the impact of the acquisition on the risk profile of the insurer and assessing whether it has been incorporated into the group's ERM, ORSA and Form F reporting, including the overall assessment of group risk capital.

Summary and Conclusion

Develop and document an overall summary and conclusion regarding the review of the Form A.

Recommendations for further action, if any, based on the overall conclusion above:

- Contact the insurer seeking explanations or additional information
- Require additional interim reporting from the insurer
- Meet with the insurer's management
- Other (explain)

Analyst:	Date:
Supervisor Review:	Date:
Supervisor Comments:	

Non-Lead State Holding Company System Analysis Procedures

Refer to section VI.C. Group-wide Supervision - Insurance Holding Company System Analysis Guidance (Lead State) for additional guidance on holding company analysis procedures.

Forms A, B, D, E (or Other Required Information), and Extraordinary Dividend/ Distribution

Forms A, D, E (or Other Required Information) and Extraordinary Dividends/Distributions are transaction specific and are not part of the regular annual/quarterly analysis process. The review of these transactions may vary, as some states may have regulations that differ from these forms.

Form A – Statement of Acquisition of Control of or Merger with a Domestic Insurer

The *Insurance Holding Company System Regulatory Act* (#440) outlines specific filing requirements for individuals wishing to acquire control of or merge with a domestic insurer. Form A is filed with the domestic state of each insurer in the group. Every attempt should be made to coordinate the analysis and review of holding company filings among all impacted states and other functional regulators to avoid duplicate processes. The domestic state or lead state should communicate the filing with all impacted states.

The period for review and action on proposed affiliations for transactions falling under the Gramm-Leach-Bliley Act (GLBA) is limited to 60 days prior to the effective date of the transaction. Under GLBA Section 104(c)(2), the states have a 60-day period preceding the effective date of the acquisition, change, or continuation of control in which to collect information and take action. Individual state statutes and regulations may or may not impose other time limitations on the review period.

Form B – Insurance Holding Company System Annual Registration Statement

Model #440 defines insurance holding companies and the related registration, disclosure, and approval requirements. Form B is the insurance holding company system annual registration statement. Model #440 requires every insurer, which is a member of an insurance holding company system, to register by filing a Form B within 15 days after it becomes subject to registration, and annually thereafter. Any non-domiciliary state may require any insurer that is authorized to do business in the state, which is a member of a holding company system, and which is not subject to registration in its state of domicile, to furnish a copy of the registration statement.

An insurance holding company system consists of two or more affiliated individuals, one or more of which is an insurer. An affiliate is an entity that directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with, another entity. Control is presumed to exist when an entity or person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies, representing 10% or more of the voting securities. The review of Form B should be completed by Oct. 31st for analysis conducted by a lead state and by Dec. 31st for analysis conducted by a non-lead state.

Form D – Prior Notice of a Transaction

Model #440 requires each insurer to give notice of certain proposed transactions. Form D must be filed with the domestic state. Material transactions include but are not limited to sales, purchases, exchanges, loans, extensions of credit, guarantees, investments, reinsurance, management agreements, service agreements and cost-sharing agreements. The transaction is considered material if for non-life insurers, it is the lesser of 3% of the insurer's admitted assets or 25% of surplus, and for life insurers, 3% of the insurer's admitted assets, each as of the most recent prior Dec. 31. Some states have stricter definitions of materiality in their holding company regulations.

Holding company regulations require that affiliated transactions be fair and reasonable to the interests of the insurer. Generally, affiliated management or service agreements should be based on actual cost in order to meet the fair and reasonable standard.

The appropriate Statement of Statutory Accounting Principle should be reviewed within the NAIC *Accounting Practices and Procedures Manual* to ensure proper accounting.

Form E (or Other Required Information) – Pre-Acquisition Notification Form Regarding the Potential Competitive Impact of a Proposed Merger or Acquisition by a Non-Domiciliary Insurer Doing Business in This State or by a Domestic Insurer

Model #440 mandates that any domestic insurer, together with any person controlling a domestic insurer, proposing a merger or acquisition to file a Form E (or Other Required Information), pre-acquisition notification form. Any differences between Model #440 and the applicable state regulations should be considered. As state requirements for Form E vary, in many states the Form E or other required information is filed to the non-domestic regulator. The insurer may also be required to file documents with the Federal Trade Commission under the Hart-Scott-Rodino Act.

The period for review and action on proposed affiliations for transactions falling under the GLBA is limited to 60 days prior to the effective date of the transaction. Under GLBA Section 104(c)(2), the states have a 60-day period preceding the effective date of the acquisition, change, or continuation of control in which to collect information and take action. It may not be mandatory for some states to approve or disapprove the Form E (or Other Required Information). These states may only have a certain period of time that an insurer's license to do business in the state is denied or a cease and desist order is put into effect.

Extraordinary Dividend/Distribution

Model #440 indicates that any domestic insurer planning to pay any extraordinary dividend or make any other extraordinary distribution to its shareholders receive proper prior regulatory approval. The insurer is required to wait 30 days after the commissioner has received notice of the declaration and has not, within that period, disapproved the payment or until the commissioner has approved the payment within the 30-day period.

Each state has its own definition of "extraordinary"; however, Model #440 defines an extraordinary dividend or distribution as any dividend or distribution of cash or other property, whose fair value, together with that of other dividends or distributions made within the preceding 12 months, exceeds the lesser of:

- 10% of the insurer's surplus as regards to policyholders as of Dec. 31 of the prior year; or
- For life insurers, net gain from operations and for non-life insurers, net income, excluding realized capital gains for the twelve months ending Dec. 31 of the prior year. This should not include pro-rata distributions of any class of the insurer's own securities.

Form A – Statement of Acquisition of Control of or Merger with a Domestic Insurer

Determination of the Ultimate Controlling Person (UCP)

For all ownership structures, when reviewing Form A applications, it is most important for the analyst to understand the terms of the ownership documents, whether traditional stock ownership or other unique or complex ownerships structures such as trusts, limited partnerships, limited liability corporations, international owners, or structures with unique share classes and voting rights. Certain agreements within the structure may convey control through unique share classes and voting rights, or through certain management or operational agreements that delegate decision making and control to a specific person or entity. For all of these structures and unique situations, it is important to identify an individual ultimate controlling person (UCP) at the top of the organizational structure, i.e., to trace the ownership/control to the top person/entity. It is at the UCP level that financial statements and other insurance holding company filings will be ~~submitted to the department.~~required to be submitted to the department, although other controlling entities (e.g., minority owners) may also be asked to provide such information when appropriate.

The state insurance department should engage the state's legal staff and other necessary internal or external expertise early in the Form A review process to assist in the review of organizational documents and agreements and in the determination of the UCP.

Review Procedures

PROCEDURES #1-2 provide instructions for the initial review of the Form A including determining if the filing is complete, establishing communication and coordination with other states and functional regulators, and updating the NAIC Form A database. States should enter the high-level information about Form A filings into the NAIC Form A Database as well as update the Form A Database with changes in status. The Form A Database allows regulators to communicate high-level information of a filing, as well as share contact information and comments on a filing. States are encouraged to use Personalized Information Capture System (PICS) alerts to notify them of Form A Database entries and updates. Such alerts would highlight any potential addition or deletion of any insurer to a Group. Contact information for the lead analyst/supervisor/chief, as applicable, responsible for the Form A review at each insurance department, as well as contact information for other functional regulators involved should be distributed to all regulators involved.

PROCEDURES #3-4 provide steps for reviewing the details of the transactions to ensure that the Form A filing is in compliance with application requirements. The procedures also suggest additional considerations and assessment of any risks and concerns regarding items such as future financial solvency of the insurer, its ability to continue to satisfy the requirements of its license, sufficiency of surplus, financial projections, debt support, suitability of affiliated agreements, technology interfacing, and dividends.

PROCEDURES #5-~~6~~7 assist analysts in reviewing the background and financial information provided in the Form A application to identify the UCP, and ~~on the ultimate controlling person (UCP)~~ to ensure that the Form A filing is in compliance with application requirements. Additionally, the procedures provide for review considerations of the UCP, Officers and Directors.

PROCEDURES #~~7-~~8-9 provide steps to ensure that information provided on purchase considerations in the Form A filing is in compliance with application requirements. In addition, the steps provide guidance for assessing the purchase considerations including source of funds & consideration, debt financing, and voting securities.

PROCEDURES #~~9-~~10-11 provide steps for assessing the impact of the acquisition on the insurance market, any concentrations/monopolies, anticompetitive impacts, and including consideration of the review of Form E-Pre-Acquisition Notification Form.

PROCEDURES #12~~1~~-17~~6~~ provides steps for completion of the approval or denial of the Form A application and developing an overall conclusion regarding the Form A.

POST-APPROVAL PROCEDURES #18~~7~~-~~29~~34 provide administrative steps for the conclusion of the Form A approval process as well as analytical steps for post-acquisition financial solvency analysis and compliance review. It is important for the department to conduct follow-up analysis and/or examination to ensure that stipulations or conditions of the acquisition approval have been met, that actual results are in line with the financial projections, business operations and strategy of the insurer that were provided with the Form A, and if not, to understand the reasons for variances.

General Statutory Standards and Risk Assessment for Form A Review

When performing the procedures listed above, it is appropriate to first consider the general statutory standards that regulators must apply in consideration of a Form A, namely that:

- The financial stability of the insurer would not be jeopardized
- Policyholders will not be prejudiced
- The acquiring party's future plans are not unfair and unreasonable to policyholders
- The transaction is not likely to be hazardous or prejudicial to the insurance-buying public

Although these are the general statutory standards that apply, analysts may need to think more broadly when considering whether these standards have been met. The point of this suggestion is to consider all aspects of the financial condition of the acquiring entity including the acquiring entity's group business model, its strategy in general and its specific strategy in purchasing the insurer, as well as any assumptions used by the acquiring entity in its evaluation of the benefits of the proposed transaction. Understanding these aspects of the proposed transaction should assist analysts in reaching a recommendation related to the proposed transaction.

Analysts are already required in other areas of this handbook to consider the prospective risks of any domiciled insurer as they perform their annual analysis and ongoing financial solvency oversight of the insurer. This also includes considering the financial condition of the entire holding company structure as defined within state law and discussed separately within this Section VI. Therefore, as analysts consider the application for change in control, it may be appropriate to consider the risks of the acquiring entity and the entire group of affiliated insurers and non-insurance affiliates under its control. In so doing, analysts should consider the group's exposure to branded risk classifications.

Branded Risks: In considering exposure to branded risk classifications, the issues of legal risk and reputational risk are generally well incorporated into the Form A application and its review. Many of the other risks (pricing and underwriting and reserving) tend to be most concentrated in the area of the insurers and therefore in these cases, it is reasonable that analysts initiate conversations with regulators of existing insurers in the applicant's group (domestic states or foreign jurisdictions) to determine if there are any concerns in these areas. However, the proposed transaction may put additional pressure on the insurer and the group from the standpoint that it may increase the leverage (operating or financial) which has the potential to increase the risks in each of these areas. The Form A application already contemplates obtaining proforma results for the insurer and the group. As analysts review proposed transaction, they may want to consider requesting additional information related to such proformas, such as how such results, and perhaps key ratios (e.g., operating or leverage) may look under certain feasible stress scenarios, particularly those that can be the most problematic for the group given its existing products or those included in its proposed business plan. However, stress scenarios should be evaluated in the context of how the company, as currently configured, would perform under the same stress scenarios. This may also be helpful in further assessing credit, market or liquidity risk. The results of such stresses should not be overemphasized, but should be considered when evaluating whether the proposed transaction meets the previously mentioned criteria. Such an analysis may also be helpful in evaluating the strategic risk of the company and the group. However, strategic risk may be difficult to evaluate without additional information beyond the proforma financial statements. This is because the proforma financial statements may not reveal enough information to permit analysts to evaluate the ability of the group to execute its business plan.

Non Insurance Affiliate Risks: More often, the risks that may be most difficult to discern are those that may exist within non-insurance affiliates because such entities may be unregulated, thereby eliminating the ability to obtain information from another regulator as can be done with insurers. Generally speaking, such non-insurance affiliates will not carry pricing and underwriting and reserving risks because those risks tend to be thought of as insurance risks. Those affiliates may however have other comparable risks, (or unrelated risks) that may be evident from a review of the proforma information. In particular, something that may not be captured in the proforma information is the other types of risks not already discussed which include or pertains to credit, market and liquidity. For some non-insurance affiliates, these risks can be more pronounced, or at least by comparison to the relative risk from the insurers within the group because state investment laws may serve as a deterrent to excessive amounts of such risks. Consequently, in addition to considering the information provided in proforma financial statements and even stressed proforma financial statements, analysts may need to obtain additional information in order to evaluate whether the proposed transaction meets the four previously identified general standards. In order to evaluate credit, market and liquidity risk, analysts should evaluate the potential enterprise risks posed to the insurer from other non-insurance affiliates, and may need to request information regarding the investment portfolio of the entire group. In all cases where information is sought relating to non-insurance affiliates, controlling individuals and other equity holders, care should be taken to ensure that confidentiality of such information can be appropriately protected.

In some cases, this may require more detailed information regarding investments such as LLCs, equity and other fund holdings and other invested assets (BA for insurer). In cases where the investment portfolio appears to be complex, analysts may need to consider engaging an investment specialist and actuary to review the entire proposed transaction to determine if the investment strategy and related affiliated agreements are appropriate or not excessively risky for the backing of the insurance contracts from a risk and asset/liability matching perspective, respectively.

Such a review would consider the reasonableness of equity firm fees and other fee structures, if any, charged or to be charged to the insurance company, as well as any similar arrangements, proposed or existing, between the insurance company and affiliated broker-dealers. Unreasonable charges to the insurance company is a particular risk that can be common in many different types of holding company structures. Because of this risk, states may need to look to authority within their holding company laws to review and deny transactions that have the potential to excessively charge the insurer for certain services and transactions if the costs are not excessive in comparison to costs for a similar transaction with a non-affiliated entity. Prior to agreeing to the proposed Form A, it may be appropriate to consider whether such contracts exist and to review them.

Analysts should also consider reviewing arrangements with parties that may not be affiliates by definition, but may be parties that appear to be engaging in a manner that is similar to an affiliate. The primary concern is whether these arrangements could be excessively charging the insurer for certain services. Another concern includes the creation of relationships that are used to prevent full disclosure of the entirety of activities within the holding company structure. Again, in many cases the primary concerns with a proposed transaction may be derived from the credit, market and liquidity risk of the non-insurance affiliates (or related strategic risks), and this type of analysis may be necessary in cases where these risks may pose enterprise risks to the insurer. Further analysis of these presumably unrelated party transactions may be necessary to determine if the risks of the non-insurance affiliates may pose enterprise risks that may affect the insurer.

In many cases, provided the application includes information on the overall investment portfolio, it may be unnecessary to seek more detailed information and to perform a more detailed review by an investment specialist. In many cases, providing a five-year plan of operation may be sufficient. This type of plan can also be helpful in mitigating the need for future detailed information on the group's investments when investments, reinsurance or other items are not a concern, or do not change materially.

Conditions and Stipulations for Form A Approval

After considering all of the risks of the proposed transaction, analysts and the states may determine that the proposed transaction either meets the general standards previously referred to, or can be met with the addition of certain stipulations agreed to by the acquiring entity. These stipulations can include such things as those listed below:

Stipulations for limited period of time:

- 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 the insurer from paying any ordinary or extraordinary dividends or other distributions to shareholders unless approved by the Commissioner.
- Requiring a capital maintenance agreement from or establishment of a prefunded trust account by the acquiring entity or appropriate holding company within the group.
- 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.

<u>Continuing stipulations:</u>

- 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 the 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.

With respect to the above, although each has its own limitations, they may provide additional assurances. For example, a capital maintenance agreement has a number of pros and cons, but, regardless it can simply raise awareness to the ultimate controlling party of the need to be a good corporate citizen.

Post Approval Review

Even after the proposed transaction has been approved, or approved with stipulations, it may be appropriate to use existing authority to perform either an annual or otherwise targeted examination of certain risks or use of ongoing (e.g., quarterly) conference calls or meetings to ascertain whether the proposed transaction and the business plan are being executed as anticipated. These are not things that would be done all the time, but only where necessary to give regulators the appropriate comfort level.

During such an examination or meeting, analysts may want to consider (as an example) any of the following procedures, using a specialist where deemed appropriate:

- Examining the insurer and its affiliates to ensure that the investment strategy provides a prudent approach for investing policyholder funds or does not create excessive contagion risk.
- Requiring ongoing annual stress testing of the insurer and the group in accordance with existing laws and regulations. This includes stress testing not only the investments but also the policyholder liabilities to ensure that the assets and liabilities continue to be properly matched.
- Conducting periodic and possible ongoing review of the investment management and other affiliated agreements, including a review of the equity firm fees and fee structure charged or to be charged to the insurer, if any, as well as arrangements with intercompany broker to ensure that they continue to be fair and reasonable. Also examine the flow of funds related to such agreements.
- Coordinating a meeting with multiple regulators and even all states to the extent there is a need for all regulators to better understand the business plan and operations of the group.
- Coordinating an examination with another regulator of a non-affiliated insurer where the direct writer has ceded a material portion of its risk to a separately controlled insurer.

Lead State Role in Form A Reviews and Disclaimers of Control/Affiliation

The lead state(s) or designee should assume the role of the coordinator and communication facilitator in a Form A and disclaimers of control/affiliation review. The lead state(s) should serve as the facilitator and central point of contact for purposes of gathering and distributing information to all regulators involved. If the lead state(s) delegate this responsibility to another domestic state within the group, all regulators, domestics and licensed states should be informed.

In identifying the UCP, the lead state should lead a discussion among the domestic states regarding who should be identified as the UCP, and therefore the person/entity primarily responsible for making insurance holding company filings. The lead state and the domestic states should come to an agreement as to who is the UCP and who is disclaimed from control (if anyone).

Where disclaimers of control/affiliation have been filed in multiple domestic states for insurers in the group, the lead state should coordinate the communication of disclaimers received, each state's review and approval/denial of the disclaimer, as well as coordinate discussions on any conditions and stipulations being considered on disclaimer approvals. The lead state should lead a discussion among the domestic states regarding each states' decision on any disclaimers that are allowed and at what percentages of control those disclaimers were allowed.

The lead state(s) or designee should schedule regular conference calls or arrange for regular e-mail communications, as deemed necessary, to receive and share status updates from each regulator involved. As many states have strict timeframes within which to complete reviews and schedule hearings, the frequency of conference calls and other communication will depend on the timelines of the particular states involved and the sensitivity of the transaction. Additionally, regulators can share comments regarding a filing in the Form A Database. The lead state(s) or designee should compile questions and issues identified by all domestics, licensed states and functional regulators in an unbiased manner in order to coordinate the resolution of the answers to the applicable parties and reduce duplicative requests.

Review results, either internally prepared or work performed by hired consultants, or information collected by a state should be shared between the applicable regulators, where permissible. Collaborative sharing of information during the review process will reduce duplicative efforts and costs for both regulators and insurers. If the use of consultants is deemed necessary, regulators should consider coordinating the selection of the consultant and agree to share the work product of the consultant.

The lead state(s) or designee should coordinate a consolidated public hearing, if deemed necessary by the lead state as set forth in ~~the *Insurance Holding Company*~~ Model ~~*Act*~~ ~~(~~#440~~)~~ ~~§~~Section 3(D)(3). Refer to the state's laws regarding public hearing requirements.

Merger(s) or consolidation of two or more insurers within the same Holding Company System (Section 3(E)~~-~~(1))

To the extent that the merger or consolidation transaction is subject to prior approval filing under other laws of the states in which the merger/consolidation entities are licensed, the merger or consolidation is exempted from filing under the Holding Company Act.

Merger or consolidation of entities of an insurer with one or more non-insurers or insurance entities. The domestic regulator should have a clear understanding of the merger or consolidation with the following documentation requested from the insurer:

- Nature of and the reason for merger/consolidation
- Evidence relating to why the merger/consolidation is fair and reasonable
- Operational and financial impact of the merger/consolidation transaction to the domestic insurer
- If subject to oversight by another functional regulator, seek material solvency concerns or regulatory concerns affecting the domestic insurer(s) or the holding company system
- If the non-insurer is subject to oversight by another functional regulator, evidence of communication and approval of the transaction by the functional regulator

Acquisitions of Control Exemption

The general premise of the exemption provision applicable under Section 3(E)~~-~~(2) for acquisition of control of an insurer within the same Holding Company System assumes minimal impact upon the insurer on the acquisition. Such assumptions should include the considerations that:

- The ultimate controlling person of the insurer being acquired remains the same
- No debt, guarantee, or other liability incurred as related to the transaction
- No significant impact upon the financial position and operations of the insurer

However, there must be a need for the acquisition of control to take place. The emphasis may not be the insurer being acquired, but the entity that is acquiring the insurer. The holding company restructure may be related to strengthen the financial position of the acquiring entities by reallocation of the stock ownership of the insurer to the acquiring entity in lieu of any cash contributions. Or the holding company restructure is to realign companies in preparation for sale of the insurer.

The domestic regulator of the insurer being acquired should request the following documentation:

- Nature of the acquisition
- Consideration of the acquisition
- Organizational chart – pre and post acquisition
- Operational and financial impact of the acquisition of both entities
- 3-year financial projections for the insurer
- Most recent audited financial statements of the acquiring entity
- Discussion of any anticipated changes to affiliated agreements
- If the entity acquiring the insurer is subject to oversight by another functional regulator, evidence of communication and approval of the transaction by the functional regulator.
- Biographical affidavits of all officers and directors of the acquiring entity and any intermediary company(s), to help ascertain the competence, experience and integrity of these individuals.
- All of the actual documents to be executed related to the acquisition.

Standards of Management of an Insurer Within a Holding Company System

Form A Exemptions

The following are suggestions for additional oversight when considering an exemption under Model #440 Section 3E(2) of the Holding Company Act. Specifically, the following should be considered when reviewing an exemption pertaining to investment managers/advisors that hold proxies directly or indirectly which may have more than 10% control.

Reputational Risk – Market Disruption Regarding 10% Investor Limitation

An investor with a large percentage of Holding Company stock may be entitled to divest significant shares, therefore driving the stock price down. This may cause a drop in the confidence levels of investors and policyholders and may also lead to ratings downgrades (if in combination with other issues).

Best Practices

- Although an exemption from change in control of over 10% may be contemplated for a "fund manager," consideration should be given to limit the stock ownership by an individual or group of mutual funds or commonly-managed companies to no greater than 9.9%.
- As part of the review process, obtain written confirmation of the percent limitation in individual mutual funds.
- The domestic insurer's awareness of the exemption request.
- The request does not violate the domestic insurer's bylaws.

Operational Risk – Ability to Influence Management and Policy Decisions

An investor with a large percentage of Holding Company stock may inherently have the ability to influence management and policy.

Best Practices

- Upon reviewing the exemption from change in control, the regulator should inquire not only about the ability of the investor to obtain a board seat, but also about the ability of the investor to become a "non-voting observer" on the board. Holding Company board controls should be firmly in place to assure that "influencing policy and management decisions" cannot occur.
- Board governance should be reviewed.

Financial Risk – The Financial Condition of Holding Company and Insurer Deteriorates

Reputational and operational risk (discussed above) can lead to financial risks.

Best Practice

The approval of the exemption from change in control should include a requirement that the State receive an attestation from the investor stating when there are changes in investing philosophy.

Disclaimer of Control/Affiliation

Section 4K of Model #440 outlines specific requirements for filing a disclaimer of affiliation by the insurer or any member of the insurance holding company system.

Consideration should be given to situations where a disclaiming party may exert influence or control over the insurer such as: over management decisions, or the operations of the insurer; where there is a minority owner; where lending agreements may result in ownership of the insurer in the event of default; where non-voting shareholders have protective rights affording them the opportunity to acquire control in certain circumstances; any non-voting arrangement or contract that may convey an element of control (e.g., investment management, reinsurance, administrative service, employment); or passive investment companies with more than 10% ownership of voting shares within funds they manage, where the actions and activities do not support that the investment company's assertion that it does not exert control.

These are only a few examples of situations that may require additional inquiry and a deeper review of the disclaimer application to determine if control exists, if the disclaimer should be approved or denied, or if any conditions or stipulations should be placed on the approval. The burden of proof is on the applicant to demonstrate they do not have control or affiliation.

Best Practices

- Consider state laws that require limitations on investments (e.g., three-year waiting period). These laws could vary by state. It is recommended that domestic states communicate and collaborate to reach an agreement on the approval of the disclaimer and the percentage limitation.
- Monitor annual financial statements for minority ownership and disclaimer disclosures in Schedule Y, Part 3.
- If the disclaimer approval includes stipulations or conditions, consider the following:
  - In situations where ownership percentages may fluctuate, require a condition whereby the disclaiming party must reapply for the disclaimer if the percentage ownership exceeds a specified percentage.

- Require 30-day notice to the Department if a "passive owner" is acting counter to management recommendations for proxy voting.
- Require that the domestic insurer is responsible for notifying the Department if any of the conditions/stipulations in the disclaimer approval are violated.
- Include in the disclaimer approval letter what the consequences will be for violating the conditions/stipulations (e.g., the disclaimer would be rescinded).
- If a disclaimer is requested for tax purposes and is relied upon by the tax authority (or similar situation where the Department has concerns that another regulatory authority may be unduly relying on the disclaimer), consider including a statement in the disclaimer approval letter that makes it clear that the approval is for state insurance law purposes only.

- In situations such as reinsurance side car or other similar arrangements where a third party appears to have influence through operational management, investment management or other agreements (e.g., the disclaimer is requested for tax purposes):
  - As part of the approval of the disclaimer, require the service agreements between the domestic insurer and the third party be submitted for Department approval (not including all holding company filings).

Inquiries to the Applicant

The following provides guidance on additional inquiries the regulator may make of the applicant(s) to gain a better understanding when reviewing disclaimers of control/affiliation.

1. Request any additional information needed to effectively evaluate the disclaimer application. Consider if sufficient information has been provided to understand the relationship of the disclaiming party.
2. Ensure the applicant addresses Board of Director membership, management positions, covenants in lending agreements (including a copy of the lending agreement), organizational charts to understand relationships, and material relationships that are in place with the company (e.g., consulting).
3. Ask for information about commitments regarding voting stock.
4. Ask the applicant(s) whether they have any agreements or understandings with any other individual or entity, written or verbal, limiting their control of the insurer.

Post-Disclaimer Considerations

- Additional disclosure requirements may be requested on an ongoing basis which may be part of the disclaimer approval.
- Review and monitor the Financial Statement for minority owner and disclaimer disclosures to make sure they are reporting Schedule Y Part 3 correctly.
- Consider if the disclaimer has an impact on who is designated the lead state for the group and therefore which state will perform holding company analysis in the future.
- The disclaiming person/entity should:
  - Provide notice before taking action on any of the rights and privileges of the non-voting shares.
  - Provide notice before transferring non-voting shares.
  - Provide notice before taking any position at the insurer or its affiliates.
  - If the facts and circumstances for which the approval of the disclaimer was based on change, they must notify the state insurance regulator.

- Perform a review of annual statement related party disclosures (e.g., Schedule Y, Notes to the Financials, and the electronic column of the investment schedules) to ensure that despite the approval of a disclaimer of affiliation, the insurer is correctly reporting any disclaimed party as a related party for material transactions pursuant to SSAP No. 25.

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Exposure to Catastrophic Events

3. Determine whether concerns exist regarding the insurer's exposure to catastrophic events, including the potential for increased physical losses, prospectively, due to climate change.

	Other Risks
a. Review Annual Financial Statement, Schedule T and the writings section in the Financial Profile Report (or the Mix of Business Dashboard) to evaluate the top states in terms of direct premiums and the percentage of total DPW in those states. Based on the lines of business written, determine whether there is a material concentration of premiums written in areas prone to catastrophic events.	ST
b. Review information provided by the insurer in the RCAT (PR027) section of its Risk Based Capital filing to identify and assess the insurer's current exposure to catastrophic events at modeled worst year in 50, 100, 250, and 500 levels on both a gross (direct and assumed) and net basis (after reinsurance). Evaluate the potential impact of the company's modeled loss results on its capital and surplus and RBC position.	ST
c. Review the Interrogatory on Catastrophe Risk Reinsurance Program RCAT (PR027) section of the insurer's Risk Based Capital filing. If necessary, request additional information or clarification from the insurer to gain a comprehensive understanding of its catastrophe reinsurance program and any recent changes in coverage due to market conditions. i. Evaluate the adequacy of reinsurance protection; for example, evaluate the impact that multiple, smaller events could have on the insurer's financial position if they fall below retention levels. ii. Identify any exclusions in the reinsurance treaties that could leave the insurer exposed to unexpected losses. iii. Assess the financial strength and creditworthiness of the reinsurers involved. Assess any potential concentration risk where the insurer relies heavily on one reinsurer. iv. Review the insurer's claims handling practices for catastrophe events, including factors such as reserving adequacy, loss adjustment expenses, and reinsurance recoveries.	ST
~~c.~~ d. Review information provided in the insurer's response to the NAIC's Climate Risk and Disclosure Survey (if available) on its exposure to physical losses impacted by climate change, as well as its related mitigation activity. i. Determine whether any of the company's responses require further investigation and inquiry.	ST
~~d.~~ e. Review information provided in the ORSA Summary Report and/or SEC 10K or 10Q filings (if available) regarding the insurer's exposure to physical losses impacted by climate change, as well as its related mitigation activity.	ST
~~e.~~ f. Utilize the information gathered and/or request additional information as necessary to	ST

assess the insurer's exposure to climate/catastrophic risks, as well as processes and strategies in place to limit exposures. i. Gain an understanding of how the company incorporates catastrophe modeling results into its underwriting processes (e.g., assessment of risk appetite or determination of net retained risk). ii. Gain an understanding of and evaluate the potential impact of climate change on the company's business and underwriting strategy over medium and longer-term time horizons. iii. Determine whether there are any concerns regarding the company's risk management processes in regard to climate change, both currently and prospectively.	

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Exposure to Catastrophic Events

PROCEDURE #3 assists analysts in identifying and assessing the insurer's current and prospective exposure to catastrophic events as well as the risk management practices of insurers writing a significant percentage of their business in products and geographic areas that are exposed to severe loss events. ~~These types of c~~Catastrophic ~~risk exposures~~events have ~~frequently been the cause or~~historically contribut~~ing~~ed ~~factor in~~to insurer insolvencies. Various steps included in this procedure assist in identifying the potential concentrations of exposure through a review of information provided in the annual statement as well as additional information provided within the RBC filing regarding modeled catastrophic risk exposures.

The Catastrophe Risk Charge in RBC (RCAT or PR027) is required to be completed by all insurers filing on the Property/Casualty blank unless they are exempted from filing due to limited exposure to property lines or coverage in catastrophe-prone areas. Insurers that are not exempted from this charge are required to provide modeled loss outputs from an approved catastrophe model for the worst year in 50, 100, 250, and 500, using the insurance company's own insured property exposure information as inputs to the model. Insurers are not required to utilize any prescribed set of modeling assumptions but are expected to use the same exposure data, modeling, and assumptions used in its own internal catastrophe risk management process.

If the analyst identifies potentially significant concentrations or exposures in writings or modeled losses, ~~the analyst should gain an understanding of the~~further investigation into the insurer's risk mitigation practices ~~in place to identify, monitor and mitigate significant exposures~~is crucial. An understanding could be gained through a review of existing information available to the analyst through company responses to the NAIC Climate Risk Disclosure Survey, RBC Interrogatory on the insurer's Catastrophe Risk Reinsurance Program RCAT (PR027), ORSA Summary Report filings, or public information sources such as SEC 10K or 10Q filings. If these existing information sources are not available or do not provide adequate details of exposures and risk management practices, the analyst is encouraged to reach out to the company to request and review additional information.

In reviewing the insurer's exposure to catastrophic losses, it is important to consider both the current and prospective nature of the exposures. Increases in weather-related catastrophic losses may result from noticeable changes in climate that have been recorded over an extended period, including rising sea levels, changes in temperatures, precipitation, and/or wind patterns. The concern is that climate change or change in weather patterns may increase the severity and frequency of future weather events including, but not limited to: thunderstorms, including severe hail and strong winds; tornadoes; hurricanes; windstorms; floods; heat waves; drought; and wildfires. If the insurer is exposed to significant catastrophic losses that could be the result of climate change, the analyst should ~~take steps to gain an understanding of and~~ evaluate the potential impact on the company's business and underwriting strategy over medium and longer-term time horizons.

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Introduction

The process for assessing enterprise risk management (ERM) within the group will vary depending upon its structure and scale. Approximately 90 percent of the U.S. premium is subject to reporting an annual Own Risk Solvency Assessment (ORSA) Summary Report. However, all insurers are subject to an assessment of risk management during the risk-focused analysis and examination, and this review is a responsibility of the lead state. In addition, all groups are required to submit the Form F - Enterprise Risk Report under the requirements of the NAIC *Insurance Holding Company System Regulatory* Act (#440) unless they have been granted an exemption by the state. In addition, both the ORSA Summary Report and the Form F are subject to the supervisory review process, which contemplates both off-site and on-site examination of such information proportionate to the nature, scale and complexity of the insurer/group's risks. Those procedures are discussed in the following two sections. In addition, any risks identified throughout the entire supervisory review process are subject to further review by the lead state in either the periodic meeting with the insurer/group and/or any targeted examination work. When reviewing the ORSA and Form F, the lead state analyst should consider consistency between the documents, as well as information provided in the Corporate Governance Annual Disclosure (CGAD).

ORSA Summary Report

The NAIC *Risk Management and Own Risk and Solvency Assessment Model Act* (#505) requires insurers above a specified premium threshold, and subject to further discretion, to submit a confidential annual ORSA Summary Report. Model #505 gives the individual insurer and the insurance group discretion as to whether the report is submitted by each individual insurer within the group or by the insurance group as a whole. Regardless of whether the ORSA is filed on an individual or group basis, any noninsurance operations that present material and relevant risks to the insurer should be included in the scope of the ORSA Summary Report. (See the NAIC *Own Risk Solvency Assessment Guidance Manual* (ORSA Guidance Manual) for further discussion).

- **Lead State:** In the case where the insurance group chooses to submit one ORSA Summary Report for the group, it must be reviewed by the lead state. The lead state is to perform a detailed and thorough review of the information and initiate any communications about the ORSA with the group. The suggestions below set forth some possible considerations for such a review. At the completion of this review, the lead state should prepare a thorough summary of its review, which would include an initial assessment of each of the three sections. The lead state should also consider and include key information to share with other domestic states that are expected to place significant reliance on the lead state's review. The lead state should share the analysis of ORSA with other states that have domestic insurers in the group. The group ORSA review and sharing with other domestic states should occur within 120 days of receipt of the ORSA filing.

- **Non-Lead State:** Non-lead states are not expected to perform an in-depth review of the ORSA, but instead rely on the review completed by the lead state. The non-lead states' review of the lead state's ORSA review should be performed only for the purpose of having a general understanding of the work performed by the lead state, and to understand the risks identified and monitored at the group-level so the non-lead state may better monitor and communicate to the lead state when its legal entity could affect the group. Any concerns or questions related to information in the ORSA or group risks should be directed to the lead state.

- **Single Insurer ORSA:** In the case where there is only one insurer within the insurance group, or the group decides to submit separate ORSA Summary Reports for each legal entity, the domestic state is to perform a detailed and thorough review of the information, which would include an initial assessment of each of the three sections and initiate any communications about the ORSA directly with the legal entity. Such a review should also be shared with the lead state (if applicable) so it can develop an understanding of the risks within the entire insurance group. Single insurer ORSA reviews should be completed within 180 days of receipt of the ORSA filing.

Throughout a significant portion of the remainder of this document, the term "insurer" is used to refer to both a single insurer for those situations where the report is prepared by the legal entity, as well as to refer to an insurance group. However, in some cases, the term group is used to reinforce the importance of the group-wide view. Similarly, throughout the remainder of this document, the term "lead state" is used before the term "analyst" with the understanding that in most situations, the ORSA Summary Report will be prepared on a group basis and therefore reviewed by the lead state.

Background Information

To understand the appropriate steps for reviewing the ORSA Summary Report, regulators must first understand the purpose of the ORSA. As noted in the ORSA Guidance Manual, the ORSA has two primary goals:

1. To foster an effective level of ERM at all insurers, through which each insurer identifies, assesses, monitors, prioritizes and reports on its material and relevant risks identified by the insurer, using techniques that are appropriate to the nature, scale and complexity of the insurer's risks, in a manner that is adequate to support risk and capital decisions.
2. To provide a group-level perspective on risk and capital, as a supplement to the existing legal entity view.

In addition, separately, the ORSA Guidance Manual discusses the regulator obtaining a high-level understanding of the insurer's ORSA and discusses how the ORSA Summary Report may assist the commissioner in determining the scope, depth and minimum timing of risk-focused analysis and examination procedures.

There is no expectation with respect to specific information or specific action that the lead state regulator is to take as a result of reviewing the ORSA Summary Report. Rather, each situation is expected to result in a unique ongoing dialogue between the insurer and the lead state regulator focused on the key risks of the group. For this reason, as well as others, the lead state analyst may want to consider additional support in the form of a broader review team as necessary in reviewing the ORSA Summary Report, subject to the confidentiality requirements outlined in statute. In reviewing the final ORSA filing prior to the next scheduled financial examination, the analyst should consider inviting the lead state examiner to participate on the review team. Regardless of which individuals are involved on a review team, the 120-day or 180-day timeliness standards are applicable to the review. Additionally, the lead state analyst and examiner may want to include the review team in ongoing dialogues with the insurer since the same team will be part of the ongoing monitoring of the insurer and an ORSA Summary Report is expected to be at the center of the regulatory processes.

These determinations can be documented as part of each insurer's ongoing supervisory plan. However, the ORSA Guidance Manual also states that each insurer's ORSA will be unique, reflecting the insurer's business model, strategic planning and overall approach to ERM. As regulators review ORSA Summary Reports, they should understand that the level of sophistication for each group's ERM program will vary depending upon size, scope and nature of business operations. Understandably, less complex insurers may not require intricate processes to possess a sound ERM program. Therefore, regulators should use caution before using the results of an ORSA review to modify ongoing supervisory plans, as a variety of practices may be appropriate depending upon the nature, scale and complexity of each insurer.

General Summary of Guidance for Each Section

The guidance that follows is designed to assist the lead state analyst in the review of the ORSA and to allow for effective communication of analysis results with the non-lead states. It is worth noting that this guidance is expected to evolve over the years, with the first couple of years focused on developing a general understanding of ORSA and ERM. It should be noted that each of the sections can be informative to the other sections. As an example, Section II affords an insurer the opportunity to demonstrate the robustness of its process through its assessment of risk exposure. In some cases, it's possible the lead state analyst may conclude the insurer did not summarize and include information about its framework and risk management tools in Section I in a way that allowed the lead state analyst to conclude its effectiveness, but in practice by review of Section II, such a conclusion was able to be reached. Likewise, the lead state analyst may assess Section II as effective but may be unable to see through Section III how the totality of the insurer's system is effective because of a lack of demonstrated rigor documented in Section III. Therefore, the assessment of each section requires the lead state analyst to consider other aspects of the ORSA Summary Report. This is particularly true of Section I, because as discussed in the following paragraphs, the other two sections have very distinct objectives, whereas the assessment of Section I is broader.

Background information procedures are provided to assist the regulator in gaining an overall understanding of the ORSA Summary Report and assessing compliance with ORSA Guidance Manual reporting requirements (i.e., attestation, and entities in scope).

Section I procedures are focused on assessing the insurer's overall risk management framework. The procedures are presented as considerations to be taken into account when reviewing and assessing an insurer's implementation of each of the risk management principles highlighted in the NAIC's ORSA Guidance Manual. In assessing implementation, regulators should consider whether the design of ERM/ORSA practices appropriately reflects the nature, scale and complexity of the insurer.

Section II takes a much different approach. It provides guidance to allow the lead state analyst to better understand the range of practices they may see in ORSA Summary Reports. However, such practices are not intended to be requirements, as that would eliminate the "Own" aspect of the ORSA and defeat its purpose. As such, analysts should not expect or require insurers to organize or present their risks in a particular manner (i.e., by branded risk classification). Rather, the guidance can be used in a way to allow the lead state analyst to better understand the information in this section. Section II guidance has been developed around reviewing key risks assessed by the insurer, evaluating information provided on the assessment and mitigation of those risks and classifying them within the nine branded risk classifications outlined in the Handbook, which are used as a common language in the risk-focused surveillance process for ongoing tracking and communication. As such, the analyst should attempt to classify each key risk assessed by the insurer into a branded risk classification(s) for incorporation into general analysis documentation Insurer Profile Summary (IPS) or Group Profile (GPS) as appropriate. The branded risk classifications are intentionally broad in order to allow almost any risk of an insurer to be tracked within one or more categories, but the analyst may also use an "Other" classification as necessary to track exposures.

Section III is also unique in that it provides a specific means for assisting the lead state analyst in evaluating the insurer's determinations of the reasonableness of its group capital and its prospective solvency position on an ongoing basis. Section III of the ORSA Summary Report is intended to be more informative regarding capital than other traditional methods of capital assessment since it sets forth the amount of capital the group determines is reasonable to sustain its current business model rather than setting a minimum floor to meet regulatory or rating agency capital requirements.

Background Information

The ORSA Guidance Manual encourages discussion and disclosure of key pieces of information to assist regulators in reviewing and understanding the ORSA Summary Report. As such, the following considerations are provided to assist the regulator in reviewing and assessing the information provided in these areas.

- **Attestation** – The report includes an attestation signed by the chief risk officer (CRO) (or other executive responsible for ERM oversight) indicating that the information presented is accurate and consistent with ERM reporting shared with the board of directors (or committee thereof).
- **Entities in Scope** – The scope of the report is clearly explained and identifies all insurers covered. The scope of a group report also indicates whether material non-insurance operations have been covered. The lead state analyst could utilize Schedule Y, the Lead State report and other related tools/filings to review which entities are accounted for in the filing.

- **Accounting Basis** – The report clearly indicates the accounting basis used to present financial information in the report, as well as the primary valuation date(s).
- **Key Business Goals** – The report provides an overview of the insurer's/group's key business goals in order to demonstrate alignment with the relevant and material risks presented within the report.
- **Changes From Prior Filing(s)** – The report clearly discusses significant changes from the prior year filing(s) to highlight areas of focus in the current year review including significant changes to the ERM framework, risks assessed, stress scenarios, overall capital position, modeling assumptions, etc.

Review of Section I - Description of the Insurer's Risk Management Framework

The ORSA Guidance Manual requires the insurer to discuss the key principles below in Section I of the ORSA Summary Report. For purposes of evaluating the ORSA Summary Report, and moreover, the lead state analyst's responsibility to assess the insurer's risk management framework, the lead state analyst should review the ORSA Summary Report to ascertain if the framework meets the principles. Additional guidance is included to provide further information on what may be contemplated in assessing such principles.

Key Principles:

A. Risk Culture and Governance

B. Risk Identification and Prioritization

C. Risk Appetite, Tolerances and Limits

D. Risk Management and Controls

E. Risk Reporting and Communication

Documentation for Section I

When reviewing the ORSA Summary Report, the lead state analyst should consider the extent to which the above principles are present within the insurer. In reviewing these principles, examples of various considerations are provided for each principle in the following sections. The intent in providing these considerations is to assist the lead state analyst in assessing the risk management framework. However, these considerations only highlight certain elements associated with the key principles and practices of individual insurers that may vary significantly. The lead state analyst should document a summary of the review of Section I by outlining key information and developing an assessment of each of the five principles set forth in the ORSA Guidance Manual using the template located in the next section of this Handbook.

A. Risk Culture and Governance

It is important to note some insurers view risk culture and governance as the cornerstone to managing risk. The ORSA Guidance Manual defines this item to include a structure that clearly defines and articulates roles, responsibilities, and accountabilities, as well as a risk culture that supports accountability in risk-based decision making. Therefore, the objective is to have a structure in place within the insurer that manages reasonably foreseeable and relevant material risk in a way that is continuously improved. Key considerations in reviewing and assessing risk culture and governance might include, but are not limited to:

- **Roles and Responsibilities** - Roles and responsibilities of key stakeholders in risk and capital management are clearly defined and documented in writing, including members of the board (or committee thereof), officers and senior executives, risk owners, etc.
- **Board or Committee Involvement** – The board of directors or appropriate committee thereof demonstrates active involvement in the oversight of ERM activities through receiving regular updates from management on ERM monitoring, reporting and recommendations.
- **Strategic Decisions** – Directors, officers and other members of senior management utilize information generated through ERM processes in making strategic decisions.
- **Staff Availability and Education** – The insurer maintains suitable staffing (e.g., sufficient number, educational background, and experience) to support its ERM framework and deliver on its risk strategy. Staff is kept current in its risk education in accordance with changes to the risk profile of the insurer.
- **Leadership** – The chief risk officer (CRO), or equivalent position, possesses an appropriate level of

knowledge and experience related to ERM and receives an appropriate level of authority to effectively fulfill responsibilities. This includes clear and direct communication channels between the CRO and the BOD or appropriate committee thereof.

- **Compensation** – The insurer demonstrates that incentives, compensation and performance management criteria have been appropriately aligned with ERM processes and do not encourage excessive risk taking given the capital position of the insurer.
- **Integration** – The insurer integrates and coordinates ERM processes across functional areas of the insurer including human resources, information technology, internal audit, compliance, business units, etc.
- **Assessment** – The insurer's ERM framework is subject to regular review and assessment, with updates made to the framework as deemed necessary.

B. Risk Identification and Prioritization

The ORSA Guidance Manual defines this as key to the insurer. Responsibility for this activity should be clear, and the risk management function is responsible for ensuring the processes are appropriate and functioning properly. Therefore, an approach for risk identification and prioritization may be to have a process in place that identifies risk and prioritizes such risks in a way that potential reasonably foreseeable and relevant material risks are addressed in the framework. Key considerations in reviewing and assessing risk identification and prioritization might include, but are not limited to:

- **Resources** – The insurer utilizes appropriate resources and tools (e.g., questionnaires, external risk listings, brainstorming meetings, conference calls with regulators, etc.) to assist in the risk identification process that are appropriate for its nature, size and structure.
- **Stakeholder Involvement** – All key stakeholders (i.e., directors, officers, senior management, business unit leaders, risk owners, etc.) are involved in risk identification and prioritization at an appropriate level.
- **Prioritization Factors** – Appropriate factors and considerations are utilized to assess and prioritize risks (e.g., likelihood of occurrence, magnitude of impact, controllability, speed of onset, etc.).
- **Process Output** – Risk registers, key risk listings and risk ratings are maintained, reviewed and updated on a regular basis.
- **Emerging Risks** – The insurer has developed and maintained a formalized process for the identification and tracking of emerging risks.

C. Risk Appetite, Tolerances and Limits

The ORSA Guidance Manual states that a formal risk appetite statement, and associated risk tolerances and limits are foundational elements of a risk management framework for an insurer. While risk appetites, tolerances and limits can be defined and used in different ways across different insurers, this guidance is provided to assist the regulator in understanding and evaluating the insurer's practices in this area.

Risk appetite can be defined as the amount of specific and aggregate risk that an insurer chooses to take during a defined time period in pursuit of its business objectives. Articulation of the risk appetite statement ensures alignment of the risk strategy with the business strategy set by senior management and reviewed and evaluated by the board. Not included in the ORSA Guidance Manual, but widely considered, is that risk appetite statements should be easy to communicate, be understood, and be closely tied to the insurer's strategy.

After the overall risk appetite for the insurer is determined, the underlying risk tolerances and limits can be selected and applied to business units and specific key risks identified by the insurer. "Risk tolerance" can be defined as the aggregate risk-taking capacity of an insurer. "Risk limits" can be defined as thresholds used to monitor the actual exposure of a specific risk or activity unit of the insurer to ensure that the level of actual risk remains within the risk tolerance. The insurer may apply appropriate quantitative limits and qualitative statements to help establish boundaries and expectations for risks that are hard to measure. These boundaries may be expressed in terms of earnings, capital, or other metrics (growth, volatility, etc.). The risk tolerances/limits provide direction outlining the insurer's tolerance for taking on certain risks, which may be established and communicated in the form of the maximum amount of such risk the entity is willing to take. However, in many cases these will be coupled with more specific and detailed limits or guidelines the insurer uses.

Due to the varying level of detail and specificity that different insurers incorporate into their risk appetites, tolerances and limits, lead state regulators should consider these elements collectively to reach an overall assessment in this area and should seek to understand the insurer's approach through follow-up discussions and dialogue. Key considerations in reviewing and assessing risk appetites, tolerances and limits might include, but are not limited to:

- **Risk Appetite Statement** – The insurer has developed an overall risk appetite statement consistent with its business plans and operations that is updated on a regular basis and subject to appropriate governance oversight.
- **Risk Tolerances/Limits** – Tolerances and limits are developed for key risks in accordance with the overall risk appetite statement.
- **Risk Owners** – Key risks are assigned to risk owners with responsibility for risk tolerances and limits, including actions to address any breaches.

D. Risk Management and Controls

The ORSA Guidance Manual stresses managing risk as an ongoing ERM activity, operating at many levels within the insurer. This principle is discussed within the governance section above from the standpoint that a key aspect of managing and controlling the reasonably foreseeable and relevant material risks of the insurer is the risk governance process put in place. For many companies, the day-to-day governance starts with the relevant business units. Those units put mechanisms in place to identify, quantify and monitor risks, which are reported up to the next level based upon the risk reporting triggers and risk limits put in place. In addition, controls are also put in place on the backend, by either the ERM function or the internal audit team, which are designed to ensure compliance and a continual enhancement approach. Therefore, one approach may be to put controls in place to ensure the insurer is abiding by its limits. Key considerations in reviewing and assessing risk management and controls might include, but not limited to:

- **Lines of Accountability** – Multiple lines of accountability (i.e., business unit or risk owners, ERM function, internal audit) are put in place to ensure that control processes are effectively implemented and maintained.
- **Control Processes** – Specific control activities and processes are put in place to manage, mitigate and monitor all key risks.
- **Implementation of Tolerances/Limits** – Risk tolerances and limits are translated into operational guidance and policies around key risks through all levels of the insurer.
- **Indicators/Metrics** – Key risk indicators or performance metrics are put in place to monitor exposures, provide early warnings and measure adherence to risk tolerances/limits.

E. Risk Reporting and Communication

The ORSA Guidance Manual indicates risk reporting and communication provides key constituents with transparency into the risk-management processes as well as facilitates active, informal decisions on risk-taking and management. Transparency is generally available because of reporting that can be made available to management, the board, or compliance departments, as appropriate. However, the most important is how the reports are being utilized to identify and manage reasonably foreseeable and relevant material risks at either the group, business unit or other level within the insurer where decisions are made. Therefore, one approach may be to have reporting in place that allows decisions to be made throughout the insurer by appropriately authorized people, with ultimate ownership by senior management or the board. Key considerations in reviewing and assessing risk reporting and communication might include, but not limited to:

- **Training** – The importance of ERM processes and changes to the risk strategy are clearly communicated to all impacted areas and business units through ongoing training.

- **Key Risk Indicator Reporting** – Summary reports on risk exposures (i.e., key risk indicators) and compliance with tolerances/limits are maintained and updated on a regular basis.
- **Oversight** – Summary reports are reviewed and discussed on a regular basis by the appropriate members of management, and when appropriate, directors.
- **Breach Management** – Breaches of limits and dashboard warning indicators are addressed in a timely manner through required action by management and, when appropriate, directors.
- **Feedback** – A feedback loop is embedded into ERM processes to ensure that results of monitoring and review discussions on key risks by senior management and the board are incorporated by business unit leaders and risk owners into ongoing risk-taking activities and risk management processes.

Overall Section 1 Assessment

After summarizing the information reviewed for each of the key principles individually, the lead state analyst should provide an overall assessment of the insurer's ERM framework, including any concerns or areas requiring follow-up investigation or communication. In preparing the assessment, the lead state analyst should understand that ORSA summary reports may not always align with each of these specific principles. Therefore, the lead state analyst must use judgment and critical thinking in accumulating information to support their evaluation of each of these principles. The overall evaluation should focus on critical concerns associated with any of the individual principles and should also address any other ERM framework concerns that may not be captured within these principles.

The lead state analyst should also be aware that the lead state examiner is tasked with supplementing the lead state analyst's assessment with additional onsite verification and testing. The lead state analyst should direct the lead state examiner to those areas where such additional verification and testing is appropriate and could not be performed by the lead state analyst. Where available from prior full scope or targeted examinations, information from the lead state examiner should be used as a starting point for the lead state analyst to update. Consequently, on an ongoing basis, the lead state analyst's update may focus on changes to ERM processes and the ORSA Summary Report since the prior exam in directing targeted onsite verification and testing.

The lead state analyst, after completing a summary of Section I, should consider if the overall assessment, or any specific conclusions, should be used to update either the ERM section of the GPS (if the ORSA Summary Report is prepared on a group basis) or information in the IPS (if the ORSA Summary Report is prepared on a legal entity basis). In addition, key information from the review should be incorporated into or referenced in the Risk Assessment Worksheet (RAW) during the next full analysis (quarterly or annual) of the insurer where relevant.

Review of Section II - Insurer's Assessment of Risk Exposure

Section II of the ORSA Summary Report is required to provide a high-level summary of the quantitative and/or qualitative assessments of risk exposure in both normal and stressed environments. The ORSA Guidance Manual ~~does not require the insurer to address specified risks but it does~~ provides examples of reasonably foreseeable and relevant material risk categories (e.g., credit, market, liquidity, underwriting, and operational risks). In reviewing the information provided in this section of the ORSA, lead state analysts may need to pay particular attention to risks and exposures that may be emerging or significantly increasing over time. To assist in identifying and understanding the changes in risk exposures, the lead state analyst may consider comparing the insurer's risk exposures and/or results of stress scenarios to those provided in prior years.

Section II provides risk information on the entire insurance group, which may be grouped in categories similar to the NAIC's nine branded risk classifications. However, this is not to suggest the lead state analyst or lead state examiner should expect the insurer to address each of the nine branded risk classifications. In fact, in most cases, they will not align, but it is not uncommon to see some similarities for credit, market, liquidity, underwriting and operational risks. A fair number of insurer risks may not be easily quantified or are grouped differently than these nine classifications. Therefore, it is possible the insurer does not view them as significant or relevant. The important point is not the format, but for the lead state analyst or lead state examiner to understand how the insurer categorizes its own risks and contemplate whether there may be material gaps in identified risks or categories of risks.

Documentation for Section II

Prepare a summary and assessment of Section II by identifying and outlining key information associated with the significant reasonably foreseeable and material relevant (key) risks of the insurer per the ORSA Summary Report. Following the documentation on each key risk per the report, the lead state analysts should include an analysis of such risk. In developing such analysis, the lead state analyst is encouraged to use judgment and critical thinking in evaluating if the risks and quantification of such risks under normal and stressed conditions are reasonable and generally consistent with expectations. The lead state analyst should be aware that the lead state examiner is tasked to update the assessment by supplementing the lead state analyst's assessment with additional on-site verification and testing. The lead state analyst should direct the lead state examiner to those areas where such additional verification and testing is appropriate and could not be performed by the lead state analyst. Suggested information to be documented on each key risk, including supporting considerations, is outlined below:

- **Risk Title and Description** – Provide the title for each key risk as identified/labeled by the insurer as well as a basic description.
- **Branded Risk** – Provide information on the primary branded risk classification(s) that apply to the key risk and briefly discuss how they apply/relate.
- **Controls/Mitigation** – Summarize information known about the controls and mitigation strategies put in place by the insurer to address the key risk.
- **Risk Limits** – Provide information on any specific risk tolerances or limits associated with the key risk and how they are monitored and enforced.
- **Assessment** – Discuss how the key risk is assessed by the insurer, including whether the assessment is performed on a quantitative or qualitative basis. Describe the methodology used, the key underlying assumptions and the process utilized to set these assumptions.
- **Normal Exposure** – Summarize the insurer's normal exposure to this key risk based on budget information or historical experience.
- **Stress Scenario(s)** – Discuss the stress scenario(s) identified and applied to the key risk and how they were determined and validated by the insurer.
- **Stressed Exposure** – Provide information on the impact of the stress scenario(s) on the key risk and potential impact on the insurer's surplus position and business strategy/operations.
- **Inclusion on IPS/GPS** – Discuss whether the key risk will be recognized on the IPS/GPS of the insurer, including the risk component it will be incorporated into.
- **Regulator Review and Assessment** – Assess the adequacy of the risk assessment performed by the insurer on each key risk (including the appropriateness of controls/limits and reasonableness of methodology, assumptions and stress scenarios used) and whether any specific issues or concerns are identified that would require further investigation or follow-up communication.

After completing a summary and assessment for each key risk addressed in Section II, the lead state analyst should use the information to update the risk assessment in either the GPS (if the ORSA is prepared on a group basis) or the IPS (if the ORSA is prepared on a legal entity basis) and supporting documentation if deemed necessary. In addition, key information from the review should be incorporated into or referenced in the RAW during the next full analysis (quarterly or annual) of the insurer where relevant.

Overall Section II Assessment

The lead state analyst should complete an overall assessment of the information provided in Section II, including an evaluation of the insurer's risk assessment processes and whether all material and relevant risks were assessed and presented at an appropriate level of detail. This should include consideration of whether there is consistency between the insurer's risk identification and prioritization process discussed in Section I and risks that are assessed and reported on in Section II (i.e., have all key risks been addressed). In addition, this should focus on critical concerns associated with the assessment of individual key risks as well as whether the insurer's overall assessment process (i.e., methodology, assumptions and stress scenarios) is adequate and well-supported.

Review of Section III - Group Assessment of Risk Capital

In reviewing Section III of the ORSA Summary Report, the lead state analyst should recognize this section is generally presented in a summarized form. Although this section requires disclosure of aggregate available capital compared against the enterprise's risk capital (i.e., the amount deemed necessary to withstand unexpected losses arising from key risks), the report may not provide sufficient detail to fully evaluate the group capital position. As such, the lead state analyst may need to request the assistance of staff actuaries when available in evaluating the reasonableness and adequacy of the stress tests selected, request additional detail from the insurer in order to understand and evaluate the group capital position and/or refer additional investigation to the financial examination function.

The ORSA Guidance Manual requires the insurer to estimate its prospective solvency under stressed conditions by identifying stress scenarios that would give rise to significant losses that have not been accounted for in reserves. Furthermore, the Manual requires the insurer to estimate its prospective solvency in Section III by projecting the aggregate capital available and comparing it against the enterprise's risk capital. Insurers may include information in the ORSA Summary Report developed as part of their strategic planning and may include pro forma financial information that displays anticipated changes to key risks as well as projected capital adequacy in those future periods based on the insurer's defined capital adequacy standard. In reviewing information on prospective solvency, the lead state analyst should carefully consider projected changes to the group capital position as well as significant shifts in the amount of capital allocated to different risks, which could signal changes in business strategy and risk exposures.

In addition to evaluating the adequacy of capital, the insurer should also discuss the effect of liquidity risk on its overall solvency, including calls on the insurer's cash position due to microeconomic factors—i.e., internal operational—and/or macro-economic factors; i.e., economic shifts. The insurer should assess its resilience against severe but plausible liquidity stresses and whether the current liquidity position is within any liquidity risk appetite and/or limits. The insurer should describe in the ORSA the policies and processes in place to manage liquidity risk, as well as contingency funding or other plans to mitigate potential liquidity stresses.

Documentation for Section III

Insurance groups will use different means to manage capital and they will use different accounting and valuation frameworks. For example, they may determine the amount of capital they need to fulfil regulatory and rating agencies' requirements, but also determine the amount of capital (risk capital) they need to absorb unexpected losses that are not accounted for in the reserves. The lead state analyst may need to request management to discuss their overall approach to capital management and the reasons and details for each approach so that they can be considered in the evaluation of estimated risk capital.

Many insurers use internally developed capital models to quantify the risk capital. In these cases, the ORSA Summary Report should summarize the insurer's process for model validation to support the quantification methodology and assumptions chosen to determine risk capital. The lead state analyst should use the model validation information to assess the reasonableness of the quantification methodology and assumptions used. If the ORSA Summary Report does not provide a summary of the model validation process, the lead state analyst should request copy of the validation report prepared by the insurer. With regard to the determination of the risk capital under stressed conditions, because the risk profile of each insurer is unique, there is no standard set of stress conditions that each insurer should run. However, the lead state regulator should be prepared to dialogue with management about the selected stress scenarios if there is concern with the rigor of the scenario. In discussions with management, the lead state analyst should gain an understanding of the modeling methods used to project available and risk capital over the duration of the insurer's business plan as well as the potential changes to the risk profile of the insurer over this time horizon (i.e., changes to the list of key risks) based on the business plan. The aforementioned dialogue may occur during either the financial analysis process and/or the financial examination process.

The lead state analyst, after completing a summary of Section III, should assess the overall reasonableness of the capital position compared to the group's estimated risk capital. Additionally, the lead state analyst should also consider if any of the information, or any specific conclusions, should be used to update either the GPS or IPS.

An assessment of the reasonableness of group risk capital and the process to measure it should be provided by developing a narrative that provides the following for each individual element of the insurer's assessment of risk capital:

- **Discussion of Capital Metric(s) Used** – Discuss the method(s) used by the group in assessing group risk capital and their basis for such a decision. Identify the capital metric(s) used to estimate group risk capital, as well as the level of calibration selected. Consider whether the capital metric(s) utilized to assess the group's overall capital target are clearly presented and described. Metrics may consist of internally developed economic capital models (deterministic or stochastic) and/or externally developed models, such as regulatory capital requirements for risk-based capital (RBC) or A.M. Best's Capital Adequacy Ratio (BCAR). In discussing calibration, consider both the method used (e.g., Value at Risk, Tail Value at Risk) and its level to evaluate whether the results are calibrated to an appropriate confidence level. Discuss whether the capital metric(s) selected address all key risks of the group. Of particular importance is considering whether the metric used fits the approach used to determine the group's risk appetite. Document the extent to which the lead state analyst believes the approach used by the insurer is reasonable for the nature, scale and complexity of the group and if this has any impact on the lead state analyst's assessment of the insurer's overall risk management.
- **Group Risk Capital - By Risk and in Aggregate** – Provide information on the amount of risk capital determined for each individual key risk and in aggregate. In reviewing the results for each individual risk, evaluate whether all key risks are adequately accounted for in the metric by assessing the amount of capital allocated to each risk. Consider significant changes in group risk capital from the prior filing, the drivers of such change, and any decisions made as a result of such movement.
- **Impact of Diversification Benefit** – Discuss the impact of any diversification benefit calculated by the group in aggregating its group risk capital. Diversification benefit is typically calculated by aggregating individually modeled risk capital and then accounting for potential dependencies among those risks to allow for an offset or reduction in the total amount of required capital (group risk capital). In evaluating the group's diversification benefit, consider whether the benefit is calculated based on dependencies/correlations in key risk components that are reasonable/appropriate.
- **Available Capital** – Provide information on and discuss the amount of capital available to absorb losses across the group, recognizing that there may be fungibility issues relating to capital trapped within various legal entities and jurisdictions for which regulatory restrictions and supervisory oversight constrain the extent and timing of capital movement across the group. Describe management's strategy to obtain/deploy additional capital across the group should the need arise. Determine if there is any double counting of capital through the stacking of legal entities.
- **Excess Capital** – Discuss the extent to which the group available capital amount exceeds the group risk capital amount per the ORSA Summary Report. In evaluating the overall adequacy of excess capital, consider any concerns outlined above relating to the capital metric(s), group risk capital, impact of diversification and available capital. If the level of excess capital or its availability/liquidity is of concern, evaluate the group's ability to remediate capital deficiencies by obtaining additional capital or reducing risk where required. If further concerns exist, contact the group to discuss and communicate with department senior management

to determine whether additional investigation or regulatory action is necessary.

- **Impact of Stresses on Group Risk Capital** – Discuss whether additional stress scenarios have been applied to the model results to demonstrate the group's resiliency to absorb extreme unexpected losses, including severe but plausible liquidity stresses. This step is particularly important when reviewing the use of external capital models that may not be tailored to address the enterprise's specific exposures. Evaluate the range and adequacy of any stress scenarios applied and the resulting impact on the group's ability to accomplish its business strategy, provide sufficient liquidity and meet the capital expectations of rating agencies and regulators.
- **Governance and Validation** – Discuss and evaluate the group's model governance process and the means by which changes to models are overseen and approved. Consider whether members of senior management are adequately involved. Discuss the extent to which the group uses model validation (including validation of data inputs) and independent review to provide additional controls over the estimation of group capital.
- **Prospective Solvency Assessment** – Discuss the information provided by the group on its prospective solvency position, including any capital projections and liquidity considerations. Consider whether the business goals of the insurer and its strategic direction are adequately discussed and incorporated into the prospective solvency assessment. For example, are expected changes in risk profile presented and discussed? Also consider whether prospective solvency is projected across the duration of the current business plan. To the extent the prospective assessment suggests that the group capital or liquidity position will weaken, or recent trends may result in certain internal limits being breached, the lead state analyst should understand and discuss what actions the insurer expects to take as a result of such an assessment (e.g., reduce certain risk exposure, raise additional capital, implement contingency funding plans, etc.).

Overall Section III Assessment

In addition, after summarizing the assessment of each individual element above, the lead state analyst should provide an overall assessment of the insurer's risk capital assessment process, including any concerns or areas requiring follow-up investigation or communication. The overall evaluation should focus on critical concerns associated with any of the individual elements noted above and should also address any other risk capital assessment concerns that may not be captured within these principles.

The lead state analyst, after completing a summary of Section 3, should consider if the overall assessment, or any specific conclusions, should be used to update either the ERM section of the GPS (if the ORSA Summary Report is prepared on a group basis) or information in the IPS (if the ORSA Summary Report is prepared on a legal entity basis). In addition, key information from the review should be incorporated into or referenced in the RAW during the next full analysis (quarterly or annual) of the insurer if relevant.

Feedback to the Insurer

After completing a review of the ORSA Summary Report, the lead state should provide practical and constructive feedback to the insurer related to the review. Feedback plays a critical role in ensuring the compliance and effectiveness of future filings. Feedback also provides a means for asking follow-up questions or requesting additional information to facilitate the review and incorporation of ORSA information into ongoing solvency monitoring processes.

During the review, topics for feedback communication to the insurer can be accumulated on **Appendix A** of the template. The appendix encourages the lead state to accumulate positive attributes to reinforce the effectiveness of certain practices and information in the summary report. In addition, the appendix encourages the lead state to identify areas for constructive feedback to encourage the insurer to provide additional information or clarify the presentation of certain items in future filings. Finally, the appendix encourages the lead state to list requests for additional information that may be necessary to complete a review and evaluation of the insurer's ORSA/ERM processes.

Suggested Follow-up by the Examination Team

After completing a review of the ORSA Summary Report, the lead state analyst should direct the lead state examiner to those areas that could benefit from focused inquiries and interviews during an on-site risk-focused examination. In some instances, the analyst may want the examiner to determine, through limited testing, if the data provided and processes described in the ORSA Summary Report are consistent with the insurer's ERM/ORSA operations. These items can be accumulated on **Appendix B** of the template for follow-up and communication. If there are specific reports, information and/or control processes addressed in the ORSA Summary Report that the lead state analyst feels should be subject to additional review and verification by the examination team, the lead state analyst is expected to provide direction as to its findings of specific items and/or recommended testing and such amounts should be listed in the template by the lead state analyst. During planning for a financial examination, the lead state examiner and lead state analyst should work together to develop a plan for additional testing and follow-up where necessary. The plan should consider that the lead state examiner may need to expand work to address areas of inquiry that may not be identifiable by the lead state analyst.

In addition to this specific expectation, during each coordinated financial condition examination, the exam team as directed by the lead state examiner and with input from the lead state analyst will be expected to review and assess the insurer's risk management function through utilization of the most current ORSA Summary Report received from the insurer. Also, the lead state analyst will ask the examination team to address the unresolved questions and concerns arising from the analyst's review of the ORSA documented in the template (see Appendix B), through focused inquiries and interviews and testing during an on-site risk-focused examination. Information included in the report and the operating effectiveness of various risk management processes can be supported/tested on a sample basis (e.g., reviewing certain supporting documentation from Section I; assessing the reasonableness of certain inputs into stress testing from Section II; and reviewing certain inputs, assumptions and outputs from internal capital models).

U.S.-Based Internationally Active Insurance Group Risk Management Assessment Considerations

While the considerations covered in this chapter are generally applicable to all insurers/insurance groups filing an ORSA Summary Report, there are additional risk management assessment considerations for the supervision of internationally active insurance groups (IAIGs) that are outlined in the ORSA Guidance Manual. As such, U.S. lead states functioning as group-wide supervisors should document their assessment of the specific IAIG risk management practices, as highlighted in **Appendix C** of the template. If such practices are already assessed and documented in the general review template, the documentation provided in this appendix can state and cross-reference to where those practices are covered.

To complete the IAIG assessment, the group-wide supervisor may need to request and review additional information from the head of the IAIG, which could include an ORSA Summary Report, CGAD, and/or additional information on risk management practices at the head of the IAIG level. The group-wide supervisor should utilize other filings and resources already available to the department, including holding company filings—i.e., Form B, Form F—and public information sources, before requesting additional information to complete the assessment.

In completing the assessment, the group-wide supervisor should consider whether certain elements are more appropriately assessed and addressed, as necessary, during an on-site examination and coordinate with the examination function. In addition, the analysis function should follow up on findings from the previous examination, as well as identify and assess significant changes in operations and risk management functions at the head of the IAIG since the last examination, as appropriate.

Form F - Enterprise Risk Report

The 2010 revisions to Model #440 and *Insurance Holding Company System Model Regulation with Reporting Forms and Instructions* (#450) introduced a new filing requirement for a Form F. The Form F requires the ultimate controlling person to identify the material risks within the insurance holding company system that could pose enterprise risk to the insurer. The Form F may be completed using information contained in the financial statement, annual report, proxy statement, statement filed with a governmental authority, or other documents if such information meets the disclosure requirements. Form F is focused on disclosing the enterprise risk associated with the entire insurance holding company system including non-regulated entities. The Form F is filed with the lead state commissioner of the insurance holding company system for every insurer subject to registration under Model #440. Adoption of the applicable Form F and related confidentiality provisions outlined in the 2010 revisions to Model #440 is required for a state to be designated the lead state for Form F filings. Lead states and other domestic states receiving and sharing the Form F must have in place confidentiality agreements as prescribed in #Model 440.

Lead State Responsibility for Analysis of Form F

The Lead State should take primary responsibility for reviewing the Form F filing and should incorporate any takeaways, risks or concerns into the GPS. Takeaways, risks and concerns should be incorporated into the ERM summary in the GPS and/or the discussion of various branded risks, as deemed appropriate. There is no requirement or expectation to create a separate Form F checklist or create additional review documentation for sharing with another state or for internal documentation purposes.

If the Form F highlights any issues or risks that are only relevant to a particular insurance entity in the group, the Lead State should notify the domestic state of the issue and share the relevant information from the Form F with that state in a timely manner.

Non-Lead State Reliance on the Lead State Analysis of Form F

The Form F must be reviewed by the lead state and significant findings incorporated into the GPS. The non-lead state is encouraged to review the ERM summary and other information provided by the lead state in the GPS to access relevant information shared through Form F. There is no expectation of additional information shared by the lead state in this area, unless Form F highlights issues or risks that are only relevant to a particular insurance entity in the group. In that case, the non-lead state(s) should rely on the Lead State to proactively provide this information in a timely manner.

If there are material concerns noted in the GPS and additional information is needed, the non-lead state should request additional information from the lead state or company, if available. Such information could include additional information from the Form F filing, if relevant.

Upon the receipt of any additional information, the non-lead state should document any material concerns regarding enterprise risk that could impact the financial condition of the domestic insurer and conclude whether any of the risks identified pose an immediate material risk to the insurer’s policyholder surplus or risk- based capital position, insurance operations (e.g., changes in writings, licensure, and organizational structure), balance sheet, leverage, or liquidity.

NAIC Enterprise Risk Report (Form F) Implementation Guide

In March 2018, the Group Solvency Issues (E) Working Group adopted *the NAIC Enterprise Risk Report (Form F) Implementation Guide,* which is located at:

https://content.naic.org/sites/default/files/inline-files/committees_e_isftf_group_solvency_related_form_f_guide.pdf

As outlined in the Guide, it is intended to assist insurers and regulators in maximizing the usefulness of the Form F by proposing best practices for consideration in preparing and reviewing filings. Therefore, while the Guide does not constitute authoritative guidance for information to be included in a Form F filing, filers are requested to consider the best practices outlined within the Guide when preparing their Form F filing. By adhering to the best practices outlined within the Guide, registrants will be able to reduce the extent of regulator follow-up and correspondence necessary to utilize the information provided, which should lead to a more effective and efficient process. The regulators' goal in developing this document was to provide some consistency and uniformity across states in reviewing and utilizing information obtained through the Form F. Therefore, it is recommended that states utilize the best practices outlined in the Guide to support their review and feedback process.

Insurance holding company systems are expected to provide a Form F filing to the appropriate regulator on an annual basis, unless they have been granted an individual exemption from the reporting provisions. Situations where it might be appropriate to consider granting an exemption could include the following:

• An ORSA Summary Report has been filed with the commissioner at the ultimate controlling person (UCP) level and addresses all enterprise risk exposures that would be disclosed in a Form F filing.

• Based on the very limited size, structure and nature of an insurance holding company system, the Form F filing would not provide additional valuable information to the commissioner.

PROCEDURES #1 - 2 provides a guide to assist analysts in reviewing the Form F filing for completeness and help guide analysts through each of the major items of information required by Form F. Analysts should review Form F in conjunction with a review of Form B and should document any nondisclosure of information. As noted above, concerns should be documented in the GPS, as there is no requirement or expectation for the analyst to create a separate Form F checklist or create additional review documentation.

PROCEDURES #3 - 7 provides a guide to assist analysts in evaluating the risks described within Form F. Analysts should consider whether any enterprise risks not reported in Form F exist, and for all risks identified both within Form F and by analysts, analysts should review information available and document any concerns. Analysts should also evaluate whether the risks identified result in an impact to the insurer's financial condition (e.g., surplus, RBC, insurance operations, balance sheet, leverage, and liquidity. Risks and concerns should be documented in the GPS.

Credit Risk: Amounts actually collected or collectible are less than those contractually due or payments are not remitted on a timely basis.

The Credit Risk Assessment is focused primarily on exposure to credit risk of investments and reinsurance receivables. In analyzing credit risk, analysts may analyze specific types of investments and receivables held by insurers. Analysts' risk-focused assessment of credit risk should take into consideration the following areas (but not be limited to):

- Concentrations of investments in type and sector (i.e., diversification).
- Materiality of high-risk or low-quality investments.
- Extensive use of reinsurance.
- Credit quality of reinsurers.
- Collectability of reinsurance receivables.
- Collectability of other receivables (e.g., intercompany receivables).
- Credit quality of affiliates and subsidiaries.
- Quality of collateral held on unauthorized or overdue authorized reinsurance.
- Strategies for mitigating credit risk (i.e., counterparty risk with derivatives and off-balance sheet transactions).
- Collectibility of uncollected premium and agents' balances.

<u>Derivatives</u>: Refer to IV.A. Supplemental Analysis Guidance – Financial Analysis and Reporting Considerations for general information and a primer on derivatives.

GENERAL GUIDANCE

To assess credit risk, consider the procedures, data elements, metrics and benchmarks in this chapter.
The placement of procedures, metrics and data within credit risk is based on "best fit." Analysts should use their professional judgement in categorizing risks when documenting financial determinations of the analysis. For example, key insurance operations or lines of business may have related risks addressed in different risk categories. Therefore, analysts may need to review other risks in conjunction with credit risk.

In conducting your analysis, utilize available tools in iSite+ such as financial profile reports, dashboards, investment snapshots, jumpstart reports, and other industry aggregated analysis. Consider also external tools such as rating agency reports, industry reports, and publicly available insurer information.

Analysts are not expected to document every procedure, data or benchmark result. Rather, analysts and supervisors should use their expertise, knowledge of the insurer and professional judgement to tailor the analysis to address the specific risks of the insurer and document the applicable details within the analysis. Results of credit risk analysis should be documented in Section III: Risk Assessment of the insurer. Documentation of the risk assessment analysis should be sufficiently robust to explain the risks and reflect the strengths and weaknesses of the insurer.

Analysts should complete their credit risk assessment in conjunction with:

- A review of the Supervisory Plan and Insurer Profile Summary and the prior period analysis.
- Communication and/or coordination with other internal departments.
- The insurer's corporate governance which includes the assessment of the risk environment facing the insurer in order to identify current or prospective solvency risks, oversight provided by the board of directors and the effectiveness of management, including the code of conduct established by the board.

The following is not an all-inclusive list of possible procedures, data, or metrics. Therefore, risks identified for which no procedure is available should be analyzed by the state insurance department based on the nature and scope of the risk.

ANNUAL CREDIT RISK ASSESSMENT

Significant Investment Concentration by Asset Class

Determine whether the insurer's investment portfolio appears to be adequately diversified to avoid an undue concentration of investments by asset type, duration or issuer.

Various types of investments to total net admitted assets (excluding separate accounts) are a measure of the diversity of the insurer's investment portfolio by type of investment. The results of these ratios may also provide some indication of the insurer's liquidity. Ratios are included for most types of investments except for government and agency bonds and cash and short-term investments, which are generally very liquid and have low credit risk. In addition, the ratio of the investment in any one issuer to total net admitted assets (excluding separate accounts) is a measure of the diversity of the insurer's investment portfolio by issuer.

Procedures / Data

- Consider evaluating the following assets classes that may have credit default risk in comparison to total admitted assets to determine the level of concentration:
  - Industrial and miscellaneous bonds (unaffiliated)
  - Residential mortgaged-backed securities (RMBS), commercial mortgage-backed securities (CMBS) or other loan-backed and structured securities (LBaSS)
  - Preferred stocks
  - Mortgage loans
  - Other invested assets (Schedule BA)
  - Derivative exposure to any single Exchange, Counterparty or Central Exchange
  - Collateral Loans [Life/A&H Insurers]
  - Aggregate write-ins for invested assets
  - Investments in affiliates, subsidiaries, and parent
  - Any single investment (by issuer) in bonds, pefered stock, mortgages, or BA assets (excluding federal issuers and affiliated investments)

Additional Review Considerations

- Review the percentage distribution of assets for significant shifts in the mix of investments owned during the past five years.
- Compare the insurer's distribution of cash and invested assets to industry averages and peer averages on iSite+ to determine significant deviations from the industry and peer averages. The comparison should focus on an appropriate peer group based on insurer type and asset size.
- Review of the Annual Supplemental Investment Risks Interrogatories to identify any unusual items or areas and determine whether the insurer's investment portfolio is adequately diversified to avoid significant aggregate credit risk.
- Perform sector analysis of Schedule D holdings with assistance of the NAIC Capital Markets Bureau if concerns exist that indicate a sector of the market may be experiencing financial distress that could result in credit risk to holders of bonds or stocks in that sector.
- If concerns exist regarding counterparty credit risk on derivatives, review Annual Financial Statement, Schedule DB, Part D to identify the counterparties and use available information (e.g., rating agency reports) to identify any concerns with the credit quality of the counterparty.
- Review the Legal Risk Assessment to determine whether the insurer's investment portfolio is in compliance with the investment limitations and diversification requirements per the state's insurance laws.
- Inquire of the insurer:
  - Planned asset mix and diversification strategies.

- How the insurer manages counterparty credit risk, including diversification risk of counterparties.

Default and Volatility of Bond Exposures

The procedure assists analysts in dDetermine whether concerns exist due to the level of investment in non-investment grade bonds. Bonds which have NAIC designations of 3, 4, 5 or 6 are considered non-investment grade bonds and represent a significantly higher credit or default risk to the insurer than do investments in investment-grade bonds. In addition, the prices of non-investment grade bonds are frequently more volatile than the prices of investment grade bonds which makes the price at which bonds are held an important consideration.

The risk of impairment of bonds or other assets may be indicated by deterioration in the credit quality which may result in other-than-temporary impairments impacting income and surplus. Investment grade bonds that have declined to a non-investment grade status may not recover lost value (bondholder default risk).

Procedures / Data

- Distinguish between the different non-investment grade classes as the risks are materially different. Consider the level of exposure to non-investment grade bonds in comparison to policyholder surplus (P/C), to capital and surplus plus AVR (L/H) and to capital and suprlus (Health), to total bonds, or to total invested assets.
- Consider fluctuations in non-investment grade bond holdings by designation.
- Review Annual Financial Statement, Schedule D – Part 1A – Section 1 and compare the insurer’s holdings of non-investment grade bonds to the limitations included in *Investments in Medium and Lower Grade Obligations Model Regulation* (#340) (or similar state law). Given the potential volatility in prices and that the main concern is risk of loss to capital, an important consideration is the price at which non-investment grade bonds are held. The NAIC’s Model #340 establishes limitations on the concentration of non-investment grade bonds because of concerns that changes in economic conditions and other market variables could adversely affect insurers having a high concentration of these types of bonds.
  - Review the amount of non-investment grade bonds by NAIC designation compared to total net admitted assets (excluding separate accounts) utilizing Model #340:
    - Aggregate amount of all bonds owned which have an NAIC rating of 3, 4, 5, or 6.
    - Aggregate amount of all bonds owned which have an NAIC rating of 4, 5, or 6.
    - Aggregate amount of all bonds owned which have an NAIC rating of 5, or 6.
    - Aggregate amount of all bonds owned which have an NAIC rating of 6.

Additional Review Considerations

- If the level of non-investment grade bonds is material, review Annual Financial Statement, Schedule D Part 1A and Part 1, Jumpstart Reports (e.g., Bond Investment Designation Exception Report) and the Financial Profile Report and Dashboards to assess and understand the composition of non-investment grade bonds:
  - Amount and/or percentage of bonds in each class 3, 4, 5 or 6.
  - Fluctuations and shifts in concentrations by class; new purchases; downgrades or upgrades.
  - Concentration by sector or issuer, including affiliates.
  - Whether or not bonds have been rated by a credit rating provider (CRP) (e.g., Moody’s Investors Service, Standard & Poor’s, A.M. Best, or Fitch Ratings).
  - Issuers that the rating agencies have on negative watch.
- Inquire of the insurer:
  - Explanation of significant exposures.
  - Policies and strategy for investing in non-investment grade bonds. Determine if the insurer is adhering to those investment policies.
  - For the more significant non-investment grade bonds, consider requesting from the insurer audited financial statements and a rating agency report from a CRP for the issuer of the bonds to assess the issuer’s current financial position and ability to repay its debt.

Borrower Default for RMBS, CMBS and LBaSS Securities,

Volatility of RMBS, CMBS, and LBaSS Securities, and Prepayment Variability for RMBS

Determine whether concerns exist over borrower default risk due to the level of investments in residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS) and loan-backed and structured securities (LBaSS) or prepayment variability risk in RMBS. Lower credit quality of the borrowers (i.e., prime versus subprime) may result in higher risk of default, leading to credit losses in the event of a housing and/or commercial real estate market downturn.

Of the structured securities, RMBS can be among the most complex and volatile. RMBS convert a pool of mortgage loans into a series of securities that have expected maturities which vary significantly from the underlying pool as a result of slicing the pool into numerous tranches with different repayment characteristics. RMBS are often issued or backed by the U.S. government, and when they are, they carry very little credit risk. As a result, agency-backed RMBS have been designated category 1.

However, the credit rating does not consider the prepayment or interest rate risk inherent in the RMBS investment. Prepayment variability in RMBS could result in actual cash flows and investment yields to be materially different from expectations. If the underlying mortgage loans are repaid by the borrowers faster or slower than anticipated, the RMBS repayment streams will be affected and the expected durations will either contract or extend. Thus, the cash flows on these investments are much more unpredictable than those for more traditional bonds and the cash flows can be either more or less variable than for mortgage pass-through certificates. If the RMBS prepayments are significantly faster than anticipated, and the insurer had paid a large premium for the RMBS when it was acquired, the insurer could experience a significant loss on the investment even though the par value was received. In addition, cash flows on RMBS are harder to match with corresponding payments on policy liabilities which leads to the risk that prepayments may not be able to be reinvested in investments earning comparable yields in order to support the liability payment streams. When interest rates rise, prepayment will likely slow and the investors will be unable to take advantage of higher rates.When interest rates decline, prepayments will rise, forcing investors to reinvest at the lower rates which impacts the value of bonds on the secondary market.

<u>Procedures / Data</u>

- Review the following ratios to determine the level of concentration in RMBS, CMBS and LBaSS owned.
  - Ratio of all RMBS, CMBS and LBaSS to total net admitted assets.
  - Ratio of all RMBS, CMBS and LBaSS compared to policyholder surplus (P/C), or capital and surplus or capital and surplus [L/H or Health].
  - RMBS compared to total cash and invested assets, or to capital and surplus.
  - Any increasing trend in a material exposure from the prior year.

<u>Additional Review Considerations</u>

- Review the RMBS, CMBS and LBaSS securities categories in Annual Financial Statement, Schedule D – Part 1 for bonds with a book/adjusted carrying value (BACV) significantly in excess of par value. This could result in a loss being realized if bond prepayments occur faster than anticipated.
- Review the RMBS, CMBS and LBaSS categories in Annual Financial Statement, Schedule D – Part 1 for bonds with an unusually high effective yield.
- The effective yield on most debt securities is generally linked to its credit risk and duration. However, significant prepayment risk can also increase the effective yield.
- Review Annual Financial Statement, Schedule D, Part 1, and the Snapshot Investment Summary Report on iSite+ to assess exposure to agency versus non-agency RMBS, CMBS and LBaSS.
- Consider having the RMBS, CMBS and LBaSS modeled by an independent actuary as a part of an independent cash flow analysis.
- Inquire of the insurer:

- Estimated prepayment speeds on its RMBS. Several standardized forms of calculating the rate of prepayments of a mortgage security exist in the market. Historically, the constant prepayment rate (CPR) and the standard prepayment model of the Bond Market Association (PSA curve) are simple methods used to measure prepayments. Numerous other methods have evolved. Analysts should consider further analysis in those instances that prepayment risk appears high.
- There are many different types of RMBS, each of which have different characteristics and inherent risks. Therefore, consider requesting information from the insurer regarding the percentage distribution and amounts of each type of RMBS, CMBS and LBaSS held; planned amortization class (PAC), support bonds, interest-only (IO) tranches, and principle-only (PO) tranches to evaluate the help evaluate the riskiness of the portfolio and the level of prepayment risk in the portfolio. IO bonds are particularly volatile.
- Projected prepayment speeds on its RMBS portfolio and compare with historical prepayments, as well as the prepayment assumption at the time of purchase.

For Life/A&H Insurers:

- Consider a review of the insurer's life risk-based capital (RBC) formula or its Statement of Actuarial Opinion. The life RBC formula includes a C-3 Interest Rate Risk Component that charges insurer's for securities that have not been cash flow tested. The insurer is charged 0.5 times the excess of the statement value over the value of the security if all of the collateral was immediately repaid.
- Alternatively, or in addition, the Statement of Actuarial Opinion should be reviewed for comments regarding the modeling of the RMBS portfolio in the cash flow testing performed by the insurer.
- The rationale behind requesting information on these types of investments is to provide analysts with some insight regarding the level of prepayment risk the insurer holds in its RMBS portfolio and the measurement and monitoring tools the insurer uses to manage this risk. RBC C-3 Interest Rate Risk Component and the Actuarial Opinion cash flow testing ask the insurer to break down its RMBS portfolio by general definitional classes, each of which has its own relative level of prepayment and cash flow volatility risk. Individual insurers may use different measures and monitoring techniques. If an insurance company cannot supply this data with reasonable ease, analysts may want to look more closely at the management and monitoring systems in place for the RMBS portfolio.

Default, Volatility and Collateral Concentration of Structured Notes

Determine whether concerns exist due to the level of structured notes held by the insurer. If the amount is material compared to the the insurer's capital and surplus plus asset valuation reserve (AVR) (L/H), to policyholder surplus (P/C), or to capital and surplus (Health), the analyst should consider steps to gain a better understanding of the prospective risks of these investments and the insurer's level of investment expertise regarding these types of notes.

Structured notes are issuer bonds where the cash flows are based on a referenced asset and not the issuer credit. These notes differ from structured securities in that they do not have a related trust. Structured notes that are classified as mortgage-referenced securities are valued in accordance with *Statement of Statutory Accounting Principles (SSAP) 43R—Loan-Backed and Structured Securities* while all other structured notes are valued in accordance with *SSAP 86—Derivatives*. Some examples of mortgage-referenced securities include, secutiries issued by the Federal Home Loan Mortgage Corporation (FHLMC) (e.g., Structured Agency Credit Risk or STACR) and the Federal National Mortgage Association (FNMA). These mortgage referenced securities are not FE, and the Structured Securities Group (SSG) assigns their NAIC designation based upon modeling assumptions.

Risks related to structured notes include:

- Structured notes collateral concentration risk
  - Material investment in structured notes that may have collateral type concentration may result in concentration risk (lack of diversity) to the insurer's portfolio.
- Structured notes default

   - Structured notes may be subordinated in the overall transaction representing exposure to non-payment in event of default.
- Structured notes cash flow volatility risk (Refer to Market Risk)
   - Impact of the volatility of structured notes and the underlying asset on which its cash flows are based.

Procedures / Data
- Ratio of investments in structured notes to capital and surplus plus AVR (L/H), to policyholder surplus (P/C), or to capital and surplus (Health).

Additional Review Considerations
- Review the Annual Financial Statement, Schedule D – Part 1, to identify and understand the types of structured notes.
- Refer to any recent examination findings.
- Inquire of the insurer on such items as the structured note's use and investment strategy, the insurer's level of expertise with this type of security and controls the insurer has implemented to mitigate this risk.

Default Risk of Foreign Securities

Material exposure to foreign investments could result in credit losses if those investments are impacted by negative changes in geopolitical or foreign economic environments.

Procedures / Data
- Review the ratio of foreign bonds to total net admitted assets to determine the signficance of non-U.S. bond investments.

Additional Review Considerations
- If material and concerns exist, inquire of the insurer about the investment strategy for foreign investments and the nature of the foreign investments.
- Evaluate if the insurer is following the investment strategy as it pertains to these investments.

Default or Volatility of Mortgage Loans

Determine whether concerns exist due to the level of expsoure or the quality of investment in mortgage loans, leading to possible default risk. The risk of impairment of mortgage loans may be indicated by deterioration in the credit quality which may result in other-than-temporary impairments impacting income and surplus. Mortgage loans may be at risk based on the volatility or impacts of economic changes in geographic regions.

Procedures / Data
- Consider the following metrics to assess materiality of exposure to mortgage loan default risk.
   - Ratio of mortgage loans to total net admitted assets.
   - Increase in exposure to mortgage loans from the prior year.
   - Total mortgage loans compared to capital and surplus plus AVR (L/H), to policyholder surplus (P/C).
   - Ratio of troubled mortgage loans compared to capital and surplus plus AVR (L/H), to policyholder surplus (P/C) or to capital and surplus (Health).
   - Ratio of commercial mortgages compared to total mortgages.

Additional Review Considerations
- Utilize postal code and property type information along with the city and state location information in Schedules A and B to identify geographic concentrations and to identify differences in volatility based on the property type and geographic location.

- Review Annual Financial Statement, Schedule B – Part 1 to determine the amount of each type of mortgage loan owned. Commercial mortgages have historically been riskier investments than farm mortgages and residential mortgages.
- If concerns exist, review Schedule B – Part 1, determine the amount of each type of mortgage loan owned.
- Determine whether any of the mortgage loans are to an officer, director, parent, subsidiary, or affiliate.
- Inquire of the insurer about increases by adjustment in book value/recored investment during the year.

Default of Second Lien Mortgage Loan

Most states restrict mortgage loan investments to first liens on property, with some states allowing second liens in instances where the insurer also owns the first lien. Second liens are more risky because, in the event of default, the holder of the first lien would be repaid out of any proceeds from the sale of the underlying property prior to the holder of the second lien.

<u>Procedures / Data</u>

- Assess the materiality of exposure to second lein mortgage loans.
  - Amount of any "Other than first liens" compared to the total admitted mortgage loans [Annual Financial Statement, Assets (page 2)].

Inadequate Collateral for Mortgage Loan Risk

An important consideration in the analysis of mortgage loans is the adjusted loan-to-value and debt service coverage ratio for each property owned, which are used in the determination of the mortgage's Commercial Mortgage Risk Category and are detailed in the RBC worksheet. Out-of-date appraisals may result in inaccurate valuation, resulting in an undervalued underlying collateral asset.

<u>Procedures / Data</u>

- Review debt service coverage ratios and adjusted loan-to-values (i.e., book value/recorded investment of each loan compared to the value of the land and buildings mortgaged) of the individual mortgage loans to determine whether the mortgage loans are adequately collateralized.

<u>Additional Review Considerations</u>

- For mortgage loans with interest overdue or in process of foreclosure, review the date of the last appraisal or valuation (Schedule B – Part 1) to determine whether updated appraisals should be obtained.

Default or Volatility of Other Invested Assets (Schedule BA)

Determine whether concerns exist due to the level of investment in other invested assets (Schedule BA). The types of investments included in Annual Financial Statement, Schedule BA include collateral loans, joint ventures and partnerships, oil and gas production and mineral rights. Joint ventures and partnerships typically involve real estate. These types of assets also tend to be fairly illiquid and may contain significant credit risk. BA assets often have complex investment strategies and unpredictable cash flows. The volatility of underlying assets (e.g., certain hedge funds and private equity funds) may result in underlying assets not being adequate. Credit risks for Schedule BA assets include:

- Credit quality of the investments that may result in impairment and default.
- Complexity of BA assets.
- Adequacy of collateral of BA assets.
- Volatility of cash flows.
- Portfolio volatility driven by economic changes on BA assets.

<u>Procedures / Data</u>

- Consider the following ratios to determine the exposure to BA Asset credit risk.
  - Ratio of Schedule BA assets to total net admitted assets.

- Ratio of Schedule BA assets to policyholder surplus (P/C), to capital and surplus plus AVR (L/H), to capital and surplus (Health).
- Increase in Schedule BA Assets from the prior year, where the investments in Schedule BA assets is material.

Additional Review Considerations

Review Schedule BA to determine the amount and types of other invested assets owned and to determine whether they are properly categorized as other invested assets. Significant categories within Schedule BA are hedge funds and private equity funds. These and other investments in Schedule BA are characterized by complex strategies, lack of transparency for expected yields and cash flows, as well as high management fees.

- Review Annual Financial Statement, Schedule BA – Other Invested Assets Owned, to determine the amount and types of other invested assets owned and identify if the insurer's exposure to certain classes of BA assets are significant (e.g., hedge funds, private equity funds, etc.).
  - Determine whether concerns exist regarding the insurer's exposure to non-traditional investments, (i.e., hedge funds and private equity funds) as compared to capital and surplus and impact on liquidity.
  - Review the experience of the insurer with respect to investing in alternative investments such as hedge funds and private equity funds.
  - Obtain and review cash flow projections to ensure that the insurer understands the cash flow characteristics of such investments.
  - Perform procedures to test the accuracy of reporting for non-traditional investments.
  - Ensure that senior management and the Board of the insurer have signed off on non-traditional investments.
- Review Schedule BA to determine if a significant amount of BA assets have NAIC ratings of 3, 4, 5 or 6 or have a "Z" designation.
- Inquire of the insurer:
  - Investment strategy regarding investment in Schedule BA assets.
  - Request information necessary to determine the fair value of collateral to the amount loaned to ensure the loan is adequately collateralized.
  - See Market Risk and Liquidity Risk for other related inquiries.

Credit Quality of Assets Supporting Collateral Loans (Life/A&H Insurers)

The procedure assists analysts in determining whether concerns exist due to the level of investment in collateral loans. Analysts should review Annual Financial Statement, Schedule BA and Schedule DA. In most states, collateral loans are required to be secured or collateralized by assets which have a value in excess of the amount of the loan and which are considered admitted assets for an insurer.

Procedures / Data

- Review the following ratios to determine the level of concentration in collateral loans.
  - Ratio of collateral loans to total net admitted assets.
  - Ratio of collateral loans to capital and surplus plus AVR.

Additional Review Considerations

- Compare the fair value of the collateral to the amount loaned to determine whether the loan is adequately collateralized. In those instances where the underlying collateral is comprised of securities, analysts might consider verifying the rate used to obtain the fair value of the securities by referencing the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual).
- Review Annual Financial Statement, Schedule BA – Other Invested Assets Owned and Schedule DA – Short-term Investments, and perform the following for each such loan:
  - Determine whether the collateral for the loan is invested in a quality asset.

- Determine whether the collateral loan is to an officer, director, parent, subsidiary, or affiliate.

Impairment of Invested Assets Exposured to Climate Change and/or Transition Risk

Identify and assess the potential exposure of the insurer's investment portfolio to the impact of material climate change and/or energy transition risks. Transition risks refer to stresses on certain investment holdings arising from the shifts in policy, consumer and business sentiment, or technologies associated with the changes necessary to limit climate change. A few examples of investment holdings and sectors generally subject to greater levels of transition risk include, oil/gas, transportation, heavy manufacturing, and agriculture. The insurer's investment portfolio is subject to prospective devaluation or impairment of the assets or changes in the asset return associated with its holdings of climate-affected assets.

<u>Procedures / Data</u>

- Review the information disclosed by the insurer in its responses to the NAIC's Climate Risk and Disclosure Survey (if available) on its exposure to material climate change/energy transition risk and related mitigation activity in this area.
- Review other relevant information provided in the Own Risk and Solvency Assessment (ORSA) Summary Report, and/or U.S. Securities and Exchange Commission (SEC) 10K or 10Q filings (if available) that discusses the insurer's exposure to material climate change/energy transition risk and related mitigation activity in this area.
- Review results of basic scenario analysis conducted by the NAIC using insurers' Annual Statement filings in the NAIC's U.S. Insurance Industry Climate Affected Investment Analysis to identify potential concentrations in insurer exposure.

<u>Additional Review Considerations</u>

- Review the insurer's investment policies and strategies to assess whether material climate change, transition and asset devaluation risk considerations have been appropriately implemented into the investment processes.
- Review the most recent examination report and summary review memorandum (SRM) for any findings regarding climate change/energy transition risks.
- If concerns exist, consider requesting information from the insurer regarding its management of exposure to material climate change/energy transition risk, including how it identifies and estimates current and prospective exposures and the limits (if any) in place to avoid concentrations.

Collectability of Reinsurance Recoverables and Reinsurer Credit Quality

Determine whether reinsurance recoverables and receivables are significant and if so, whether the amounts involved are collectable. Reinsurance payments may be delayed or not be paid when due, resulting in cash flow mismatch.

Under a reinsurance contract, the primary insurer transfers or cedes to another insurer (reinsurer) all or part of the risk . Reinsurance does not modify in any way the obligation of the direct insurer to pay policyholder claims. Only after claims have been paid can the direct insurer seek reimbursement from a reinsurer for its share of paid losses. As a result, evaluating the collectability of the recoverables and receivables, as well as the overall creditworthiness of the reinsurers is important. Evaluating the collectability of reinsurance recoverables and receivables requires an understanding of the specific facts and circumstances relating to each reinsurer.

Reinsurance is generally obtained from one of the following categories of insurers:

- Professional Reinsurers – The main business of professional reinsurers is assuming premiums from non-affiliated insurers.

- Reinsurance Departments of Primary Insurers – Many insurers assume reinsurance from non-affiliates, but also write business on a direct basis. These types of insurers may pose a larger collectability concern than professional reinsurers since the specialized reinsurance expertise may not be as strong.
- Alien Insurers – Reinsurers domiciled in another country may pose a collectability concern, if the reinsurer is domiciled in a jurisdiction with a solvency framework that may not be as strong as the U.S.

The fundamental issue involved with evaluating collectability is an assessment of the financial stability of the underlying reinsurers. To evaluate the collectability of reinsurance recoverables, analysts should consider the need to collect as much financial information as necessary to evaluate the financial condition of reinsurers assuming a material portion of risk, including various regulatory and governmental filings, rating agency reports, and financial analyses available from industry analysts.

A ceding insurer may not take credit for reinsurance recoverables in dispute with an affiliate, which may result in a recoverability issue. Occasionally, a reinsurer will question whether an individual claim is covered under a reinsurance contract or may even attempt to nullify an entire treaty. A ceding insurer, depending on the individual facts, may or may not choose to continue to take credit for such disputed balances.

Collectability of Reinsurance Recoverables For Life/A&H Insurers

<u>Procedures / Data</u>
Review the following ratio results to determine whether amounts recoverable (paid and unpaid) or amounts receivable from reinsurers are significant and collectable.

- Reinsurance amounts recoverable on paid and unpaid losses on claims as a percentage of capital and surplus.
- Reserve credits as a percent of capital and surplus.
- Other amounts receivable under reinsurance contracts as a percentage of capital and surplus.
- Total amount of funds withheld for payment of losses by ceding companies as a percentage of capital and surplus.

<u>Additional Review Considerations</u>

- Review L/H Annual Financial Statement, Schedule S – Part 3 – Section 1 and Schedule S – Part 3 – Section 2 and determine if any unusual items were noted regarding the types of reinsurance or the concerns with specific reinsurers.
- If concerns exist, review the reinsurer's history of payments of recoverables and determine compliance with the NAIC *Life and Health Reinsurance Agreements Model Regulation* (#791) regarding quarterly settlements of payments due from reinsurers.
- Review the Annual Financial Statement, Notes to Financial Statements, Note #23 and determine if the insurer reported any items of concern regarding reinsurance balances.
- Determine if and assess any significant write-offs of reinsurance collectables that have occurred during the period.
- Verify by direct contact or confirmation that funds withheld for payment are valid and adequately segregated for payment of losses.
- Inquire of the Insurer the aging of reinsurance amounts payable (e.g., concerns with reinsurance related transactions that may require inquiry to the insurer)/receivable.

Collectability of Reinsurance Recoverables For P/C Insurers

Review the following ratio results to determine whether amounts recoverable (paid and unpaid losses) or amounts receivable from reinsurers are material and collectable.

- Overdue paid losses and LAE reinsurance recoverables (91 days or more) to surplus.
- Total reinsurance recoverables from unauthorized reinsurers to surplus.
- Total reinsurance recoverables from alien reinsurers to surplus.

- Provision for overdue authorized and reciprocal jurisdiction reinsurance to authorized and reciprocal jurisdiction reinsurance recoverables on paid losses and LAE in dispute.
- Non-affiliated reinsurance recoverables on paid losses to surplus.
- Non-affiliated reinsurance recoverables on unpaid losses and LAE to surplus.
- Provision for unauthorized and certified reinsurance to total reinsurance recoverables from unauthorized and certified reinsurer.
- Total amount of funds withheld for payment of losses by ceding insurers to surplus.
- Unsecured reinsurance recoverables to surplus.
- Total reinsurance recoverables from any unauthorized or certified reinsurer to surplus.
- Total reinsurance recoverables from any alien reinsurer to surplus.
- Reinsurance recoverables in dispute to surplus.
- Maximum amount of return commissions due to reinsurers in the event of cancellation of all ceded reinsurance to surplus.
- Uncollectable reinsurance written off during the year to surplus.

Another important accounting concern for P/C insurers relates to the provision for reinsurance. Under statutory accounting practices, the insurer must establish a liability by a formula that considers:

- The amount of overdue reinsurance recoverable on paid losses due from authorized insurers and reciprocal jurisdictions, certified reinsurers, or unauthorized reinsurers.
- Any collateral deficiency with respect to the amount of reinsurance recoverable on paid and unpaid losses due from certified reinsurers or unauthorized reinsurers.

<u>Additional Review Considerations</u>

- Review, by individual reinsurer, the amounts shown as collateral. Identify any unusual trends and determine the need to examine the underlying collateral in more detail to ensure its validity.
- Credit quality and poor financial strength of a reinsurer may result in future collectability risk, which may result in ongoing credit risk and future liquidity issues.
- If the insurer holds a material letter of credit (LOC) securing unauthorized and/or certified reinsurance recoverables, identify the amount of the LOC and the issuing bank. Identify any concerns and assess whether the collateral is at an adequate level.
- Review the Annual Financial Statement, Notes to Financial Statements, Note #23 and determine if there any relevant concerns regarding reinsurance balances.
- Review the reinsurer’s history of recoverables and note on findings or concerns.
- Verify by direct contact or confirmation that funds withheld for payment are valid and adequately segregated for payment of losses.
- Inquire of the Insurer the aging of reinsurance amounts payables(e.g., concerns with reinsurance related transactions that may require inquiry to the insurer)/receivable.

Collectability of Reinsurance Recoverables For Health Insurers

<u>Procedures / Data</u>

Review the following ratio results to determine whether amounts recoverable (paid and unpaid) or amounts receivable from reinsurers are material and collectable.

- Reinsurance amounts recoverable as a percent of capital and surplus.
- Ceded premiums written to gross premiums written.
- Reserve credits as a percent of capital and surplus.

<u>Additional Review Considerations</u>

- Review Health Annual Financial Statement, Schedule S – Part 3 – Section 2 and determine if any unusual items were noted regarding the types of reinsurance and their relative significance, or the specific reinsurers involved.
- Review the Annual Financial Statement, Notes to Financial Statements, Note #23 and determine if the insurer reported any items of concern regarding reinsurance balances.
- Review the results of the Actuarial Opinion analysis and determine if any concerns were noted regarding the collectability of reinsurance recoverables.
- Review the reinsurer's history of recoverables and note any findings or concerns.
- Determine if and assess any significant write-offs of reinsurance collectables that have occurred during the period.
- Inquire of the Insurer the aging of reinsurance amounts payable/receivable.

Collectability of Reinsurance Recoverables due to Credit Quality of Retrocessionaires

Additional Review Considerations

- Determine whether retrocession may be occurring that could cause significant collectability risk to the insurer if the retrocessionaire is of poor credit quality and unable to pay its obligations to the reinsurer.
  - For the five largest individual unauthorized reinsurers and the five largest individual certified reinsurers listed in the Annual Financial Statement, [P/C Schedule F – Part 3; L/H and Health Schedule S–Part 3] consider the need to obtain the reinsurer's Annual Financial Statement and determine the extent to which the reinsurer has engaged in retrocession agreements.
  - Determine if any unauthorized and/or certified reinsurers have ceded reserves greater than 50% of total gross reserves.
    - If so, consider reviewing the Annual Financial Statement of the more significant reinsurers or inquiring of the insurer, to evaluate the extent to which the reinsurers cede business to other reinsurers.
    - If significant collectability concerns surface as a result of these procedures, perform the appropriate procedures to evaluate collectability.
  - Consider discussing with the insurer and/or the reinsurer or retrocessionaire's domiciliary regulator any identified risks or concerns with credit quality of the reinsurer or retrocessionaire.

Credit Quality and Default of Reinsurer

Additional Review Considerations

Assess the credit quality and financial solvency of the reinsurers that the insurer cedes a material amount of business to or has material reinsurance recoverable due from. Credit quality and poor financial strength of a reinsurer may result in future collectability risk, which may result in ongoing credit risk and future liquidity issues.

- Determine the current ratings of the reinsurer from the major rating agencies and investigate significant changes during the past 12 months.
- Obtain and review the Audited Financial Report, Annual Financial Statement, Actuarial Opinion and U.S. Securities and Exchange (SEC) Filings (if applicable) of the reinsurer for additional insight regarding collectability and credit quality of the reinsurer.
- Review information about the reinsurer available from industry analysts and benchmark capital adequacy with top performers and peer groups.
- Contact the domiciliary state to determine whether any regulatory actions are pending against the reinsurer. Also, review iSite+ data on the reinsurer (i.e., financial statements, Regulatory Information Retrieval System [RIRS] and Global Receivership Information Database [GRID]).
- Determine whether the reinsurance transactions involved going "in and out" of treaties in such a manner that, in substance, the transactions are for financial reinsurance purposes (See Strategic Risk for more on financial reinsurance).

- Review [L/H and Health Schedule S – Part 4; P/C Schedule F] and determine if adequate levels of collateral (e.g., letters of credit) are maintained for unauthorized reinsurance and to secure outstanding losses.
- Review results of reinsurance Jumpstart Reports to determine if material differences exist between amounts reported on reinsurance schedules of the insurer compared to the ceding insurers.
  - If significant differences are noted, further investigate if the amounts appear to be due to timing and/or consider asking the insurer for aging of amounts payable/receivable.
- Review the individual authorized reinsurers listed in Schedule S – Part 3 – Section 2 and determine if any of the reinsurers generally known to enter into significant retrocession agreements.
- Inquire of the Insurer:
  - Request a copy of the insurer's A.M. Best Supplemental Ratings Questionnaire and review the reinsurance section for unusual items.
  - If concerns exist regarding the credit quality and financial solvency of an unauthorized reinsurer, request a copy of the reinsurance agreement(s), and confirm amounts included on Annual Financial Statement, [L/H and Health Schedule S – Part 4 - Reinsurance Ceded to Unauthorized Companies; P/C Schedule F – Part 3].

Reserve Credits Taken are Inapproriate (Life/A&H Insurers, Health)

Determine whether the insurer's accounting treatment for reinsurance is proper and in accordance with the *Annual Statement Instructions* to determine if the reserve credit taken is appropriate.

<u>Procedures / Data</u>

- Briefly scan the individual reinsurers listed in Annual Financial Statement, Schedule S – Part 3 – Section 1 - Reinsurance Ceded Life and Annuities and Schedule S – Part 3 – Section 2 - Reinsurance Ceded Accident and Health and Schedule S – Part 3 – Section 2 – Health and determine if any of the reinsurers classified as authorized appear to be improperly classified as such.
- Determine if there is a liability established for reinsurance with unauthorized reinsurers to the sum of reserve credits taken, paid and unpaid losses, and other debits material. [Annual Financial Statement, Schedule S – Part 4]

<u>Additional Review Considerations</u>

- Review Annual Financial Statement, Schedule S – Part 4. Determine if there are any concerns about the appropriateness of reinsurance credits taken. Note any concerns in the Statement of Actuarial Opinion regarding the insurer failing to properly establish a reserve relating to reinsurance assumed from another reinsurer for accident and health.
- Briefly scan the Annual Financial Statement pages relating to Assets; Liabilities, Surplus and Other Funds; and Summary of Operations and determine if any unusual items are noted relating to write-ins or significant changes or inconsistencies from prior years regarding reinsurance activities.
- Generate Examination Jumpstart analysis to determine whether ceding company credits are appropriately "mirrored" by the reinsurer, after considering the impact of normal timing delays.
- If the insurer holds a material LOC securing unauthorized reinsurance recoverables, identify the amount of the LOC, the issuing bank, and the rating of the bank.

Collectiabilty of LOCs and Credit Quality of Issuing/Confirming Banks

Determine if there are credit quality or collectibilty concerns with banks that have issued or confirmed LOCs where the insurer is the beneficiary of a material LOC.

<u>Additional Review Considerations</u>

- Review Annual Financial Statement, General Interrogatories, Part 1, #15.1 and 15.2. Determine whether the beneficiary of an LOC that is unrelated to reinsurance where the issuing or confirming bank in not on the SVO Qualified U.S. Financial Institutions List.
- If "yes," identify and understand the issuing or confirming bank, the circumstances that can trigger the LOC and the amount.

Collectability of Affiliated Receivable or Payable

Consider if any affiliated transactions have exposed the insurer to significant collectability risk. Credit quality and poor financial strength of an affiliate may result in future collectability risk, which may result in ongoing credit risk and future liquidity issues. For example, if the insurer is included in a consolidated federal income tax return and a significant asset for Federal Income Tax Recoverable is recorded on the financial statements of the insurer, analysts should closely review the financial statements of the parent to determine the parent's ability to repay the receivable. Structured settlements acquired from an affiliated life insurance company may also represent a collectability risk to the insurer. When the amounts of structured settlements are significant, analysts should review and understand the financial statements and payment ability of the life insurance affiliate.

Significant affiliated payables should be considered in relation to the extent of affiliated relationships, transactions, and activities. Refer to Operational Risk for further consideration of significant amounts of affiliated payables.

<u>Procedures / Data</u>

- Review the balance sheet asset receivable from parent, subsidiaries, and affiliates, as well as the liability payable to parent, subsidiaries, and affiliates to determine whether there are concerns with the level of affiliated receivables or payables.
  - Affiliated receivable to capital and surplus (L/H, Health) or to policyholder surplus (P/C).
  - Affiliated payable to capital and surplus (L/H, Health) or to policyholder surplus (P/C).

<u>Additional Review Considerations</u>

- If there are concerns regarding collectability of affiliated receivables, review the Annual Financial Statement, Schedule Y – Part 2, Notes to the Financial Statements, Management's Discussion and Analysis (MD&A) and other available information (e.g., Form D filings) for more information about the nature and timing of the receivable.
- Review the Operations Risk Reference Guide for more procedures on affiliated transactions.

Collectabilty/Default of Investments Involving Related Parties

Determine related party exposure in the investment portfolio and assess any related credit risk.
Related parties are entities that have common interests as a result of ownership, control, affiliation or by contract as definited in *SSAP No. 25—Affiliates and Other Related Parties* (SSAP No. 25). Refer to the *Insurance Holding Company System Model Act* (Model #440) and SSAP No. 25 for a broader definition of "affiliate," "related party" and "control".

Related party transactions are subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny.

The anlayst should utilize the tools available in iSite+ to identify if the insurer has a material exposure to investments involving related parties, either on an asset category basis or in aggregate, and by the related party designation noted below. If a material exposure exists, further assessment of the credit risk may be warranted. For example, what is the NAIC designation of investments involving related parties? Analysts may also consider the extent to which related parties are involved in securitizing or originating business for the insurer, and what differences may exist in how investments involving related parties are valued (market risk). If the role of the related party is that of a third-party advisor, factors to consider may include for example, the expertise of the related party advisor, any potential conflicts of interest, and if related parties are originating investments only for the insurer or also to the public, the latter being subject to SEC requirements.

Within the Annual Financial Statement investment Schedules B, BA, D, DA, DB, DL, and E (Part 2), all investments involving related parties must incude disclosure to ensure full transparency. This disclosure is in the column "Investments Involving Related Parites". It designates investments by the following roles:

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 another similar influential role.
5. The investment is identified as a 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.

Procedures / Data

- Review the Annual Financial Statement investment schedules, as disclosed in the column "Investments Involving Related Parties" and utilizing iSite+ tools, determine if the insurer has material related party exposures in its investment portfolio. This disclosure is included in:
    - Schedule B
    - Schedule BA
    - Schedule D
    - Schedule DA
    - Schedule DB
    - Schedule DL
    - Schedule E, Part 2

  Consider exposure by asset class and in aggregate, and by the role of the related party in the investment as designed by the "Investments Involving Related Parties" disclosure.
- If concerns exist regarding a material related party exposure in the investment portfolio, assess the credit quality of those investments and assess any historical default experience.

Additional Review Considerations

If concerns exist regarding a material related party exposure in investment management or advisory services, consider the following.

- The analyst may consider utilizing suggested procedures in the "Additional Procedures" section below on third-party advisors, if applicable.
- In addition to the additional analysis procedures regarding third party investment advisors, consider the following:
    - Review the insurer's investment policy guidelines and determine whether the related party investments follow the guidelines and are in compliance with regulatory requirements.

- Review whether the fee structure for asset management is fair, reasonable, and appropriately recognized as investment expenses.
- If the related party asset manager also originates/securitizes investments held by the insurer, consider requesting additional information from the insurer to determine the following:
  - Whether the asset manager has adequate experience and knowledge in originating and managing the types of investments.
  - Whether the asset manager follows appropriate underwriting practices and applicable regulatory requirements in originating investments.
  - Whether the fee structures embedded in securities (if applicable) are fair, reasonable, and appropriately account for potential duplication of fees or conflicts of interest.

Collectability of Uncollected Premiums and Agents' Balances for P/C and Health Insurers

The asset for uncollected premiums and agents' balances in the course of collection includes amounts receivable that have been billed but have not yet been collected. Payments may be delayed or not be paid when due, resulting in a cash flow mismatch. Additionally, the credit quality and poor financial strength of an agent may result in future collectability risk, which may result in ongoing credit risk and future liquidity issues.

Agencies and brokers receive premium payments from insureds in a fiduciary capacity. Most states have laws that require the agent or producer to maintain trust accounts for the premiums they collect, which must be kept separate from their business operating funds. The premiums, net of commissions, are then remitted to the insurer or general agents from the accounts, leaving an audit trail.

Although agents are used by health entities, they are generally used more extensively with P/C insurers or even life insurers. Agents' balances are admitted to the extent that the assets conform to the requirements of *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts due from Agents and Brokers*, which also requires that premiums owed by agents should be reported net of commissions and are non-admitted under a 90-day rule. Remaining amounts that are determined to be uncollectable must be written off. Generally, if a contract with an agent permits offsetting, amounts payable to an agent may be offset against a receivable from that agent. Agents' balances carry credit risk and can have a material impact on the net income and capital and surplus of an insurer if the balances are significant. Significant or growing balances can also lead to liquidity problems if the insurer is unable to convert the receivables into cash to be used to pay claims.

Irrespective of the type of business written, inadequate systems and controls over the collection process can lead to uncollectable premiums. Uncollected premium balances on non-government business that are over 90 days due are non-admitted under SSAP No. 6. On all business, an evaluation of any remaining asset balance is required to determine any impairment. Amounts deemed uncollectable are required to be written off against income in the period the determination is made. These accounting requirements are designed to limit the total impact that collectability issues can have on an insurer at a given point in time.

Despite the efforts to mitigate the impact of uncollected premiums and agents' balances, write-offs and non-admitted unpaid premium assets can still have a material impact on the net income and capital and surplus of an insurer. These issues can lead to liquidity problems if the insurer is unable to convert the receivable into cash to be used to pay claims. Analysts should monitor the level of this asset as well as the change in the balance to help identify potential collection problems that can ultimately lead to significant decreases in surplus.

A material amount of uncollected agents' balances warrants further investigation to ensure that adequate controls are in place and that trust accounts are properly managed. An increase or trend of material non-admitted balances or write-offs may be a sign of mismanagement or misappropriation of trust accounts by the agency and should be investigated. Although this could occur at any agency, the risk is greater at affiliated agencies for the following reasons:

- The same owner controls both sides of the transaction.

- There is a lack of internal controls in relation to management overrides.
- Affiliated agency balances are often more material to small or medium-sized insurers.
- Affiliated agencies may not be subject to the same level of oversight as unaffiliated agencies.
- In the event of financial stress to the insurer or the agency, there may be an inherent conflict of interest.

If the analyst has concerns about the timely collection of agents' balances, the additional procedures related to premium trust accounts in the repository should be considered.

For Health Insurers:
The collectability of amounts reported for uncollected premiums may also be impacted as a result of retroactive additions and deletions that are made subsequent to the date the group was invoiced. There may be a delay (sometimes several months) between the time that a large group adds a new covered employee or deletes an employee that is no longer covered and notice of the change is sent to the health entity. This length of the delay increases since the invoicing of the monthly premium is frequently in advance of the effective date of the coverage. This delay can result in the health entity reporting part of the monthly billing as more than 90 days overdue and ultimately collecting less than what was billed. SSAP No. 6 states that if an installment premium is over 90 days due, the amount over ninety days due plus all future installments that have been recorded on that policy shall be non-admitted. However, for group accident and health contracts, a non-admitted *de minimus* over ninety-day balance would not cause future installments (i.e., monthly billed premiums on group accident & health) that have been recorded on that policy to also be non-admitted. The *de minimus* over 90-day balance itself would be non-admitted and the entire current balance would be subject to a collectability analysis.

The balance for uncollected premiums may also result from amounts due from the Centers for Medicare and Medicaid Services or other government plans. Although coverage periods for this type of business are usually the same as comprehensive group business, the payment cycle can be much different due to the longer settlement periods experienced under government contracts. However, collectability of balances associated with government plans is usually not an issue. Because of this, the 90-day rule that is applied to other receivables is not applicable to receivables from these types of government plans.

Procedures / Data (P/C Insurers)
Review and assess uncollected premiums and agents' balances for potential collectability issues. Consider the following ratios.
- Ratio of uncollected premiums and agents' balances to surplus [IRIS ratio #10].
- Change in uncollected premiums and agents' balances from the prior year.
- Ratio of uncollected premiums to net premium income.
- Ratio of non-admitted uncollected premiums to total uncollected premiums.
- Net agents' balances and premium balances charged off and recovered to total uncollected agents' balances and premium balances.

Procedures / Data (Health Insurers)
Review and assess uncollected premiums and agents' balances for potential collectability issues. Consider the following ratios.
- Ratio of uncollected premiums and agents' balances to capital and surplus.
- Change in uncollected premiums and agents' balances from the prior year.
- Ratio of uncollected premiums to net premium income.
- Amount due from any one group or subscriber as percent of the uncollected premiums.
- Ratio of non-admitted uncollected premiums to total uncollected premiums.
- Net agents' balances and premium balances charged off and recovered to total uncollected agents' balances and premium balances.

Additional Review Considerations (P/C and Health Insurers)

- Review amounts non-admitted and compare to prior years.
- With respect to agents' balances, verify the creditworthiness of the agent.
- Inquire of the insurer:
  - Explanation for the significant balance.
  - Listing of balances of subscribers, which individually account for 10% or more of the premiums uncollected and compare to a similar list from prior years.
  - Amounts of any uncollectable balances that have been written off in the current period. Compare the write-offs to those of the prior reporting period, if any.
  - Written procedures for monitoring and collecting uncollected premiums, including amounts already written off.
  - If the insurer has factored or sold its uncollected premium balances to a third party, note whether the receivables were discounted in the transaction.
  - Concerns over uncollected agents' balances warrant further investigation to ensure that adequate controls are in place and that trust accounts are properly managed. An increase or trend of material non-admitted agents' balances or write-offs may be a sign of mismanagement or misappropriation of premium trust accounts by the agency. If there are concerns in this area, consider the following:
    - Request additional data/information from the insurer to identify the source(s) of the balances and the reason(s) for the non-admitted or charged-off amounts.
    - Request the insurer to provide a summary of the controls in place over agencies and ensure proper management and oversight of trust accounts.
    - Request monthly reports from the insurer.
  - Discuss concerns with the exam team, including whether a targeted exam is necessary.

Collectability of Uninsured Plan Receivables for Health Insurers

Payments on uninsured plan receivables may be delayed or not be paid when due, resulting in a cash flow mismatch.

SSAP No. 47—Uninsured Plans defines uninsured accident and health plans, including HMO administered plans, as plans for which a health entity, as an administrator, performs administrative services such as claims processing for an at risk third party. Accordingly, the administrator does not issue an insurance policy. Two of the more common types of uninsured accident and health plans include an Administrative Services Only (ASO) plan or an Administrative Services Contract (ASC) plan.

Under uninsured plans, there is no underwriting risk to the health entity. The plan bears all of the utilization risk, and there is no possibility of loss or liability to the administrator caused by claims incurred related to the plan. Although there is no underwriting risk on these types of plans, credit risk can still be an issue. Under these types of agreements, it is common for a receivable to be established for services performed by the health entity, and/or amounts due to the health entity for claims paid by the health entity on behalf of the uninsured plan. The credit risk varies on these types of plans because under an ASC plan, the health entity pays the claims directly from its own bank account and would seek reimbursement at a later date. In contrast, under an ASO plan, the claims are paid from a bank account owned and funded directly by the uninsured plan sponsor or are paid by the health entity but only after receiving funds to cover the amount paid. Combination plans may also be administered which contain elements of both an uninsured and an insured plan. If the funds held for disbursement under the uninsured plans are inadequate to meet disbursement needs, the insurer may advance funds to cover such disbursements.

As a result of such advances, the receivable should be recorded as an asset. Liabilities can also result from administering this type of business. This type of liability would result from funds of the uninsured plans being held by the health entity for making plan disbursements. Generally, the asset for the receivable and the liability for funds held should not be netted unless individual receivables and payments meet the requirements of *SSAP No. 64—Offsetting and Netting of Assets and Liabilities*.

Expense risk can also result from uninsured plans. This risk results primarily from the health entity incurring more expenses to administer the business than reimbursed from the uninsured plan. Analysts should use the information in Annual Financial Statement, Notes to Financial Statements, Note #18 — Uninsured Plans, to better assess the business risk to which the health entity is exposed under its uninsured plans. Refer to Section IV.B. Supplemental Analysis Guidance – Notes to Financial Statements, for guidance on reviewing Note #18.

Procedures / Data

- Compare the ratio of ASO/ASC claim payments to total hospital and medical expenses plus ASO/ASC claim payments [Annual Financial Statement, Notes to Financial Statements, Note #18, Part A and Part B].
- Compare the ratio of reimbursements from uninsured plans to total expenses plus reimbursements from uninsured plans [Annual Financial Statement, Underwriting and Investment Exhibit – Part 3].
- Ratio of receivables relating to uninsured plans to capital and surplus.
- Change in uninsured receivable relating to uninsured accident and health plans.
- Non-admitted uninsured receivables relating to uninsured accident and health plans.

Additional Review Considerations

- Determine whether any concerns exist regarding the profitability of uninsured accident and health plans and the uninsured portion of partially insured plans for which the insurer serves as an Administrative Services Only (ASO) or an Administrative Services Contract (ASC) plan administrator. [Annual Financial Statement, Notes to Financial Statements, Note #18].
- Determine whether the insurer reported ASO and/or ASC amounts in its Risk–Based Capital (RBC) filing (worksheet XR021) and not reported receivables or assets related to uninsured accident and health plans on its Annual Financial Statement or vice versa.
- Evaluate the adequacy of funds held for the plans' claims and expenses.
- Evaluate the financial condition of the uninsured plans.
- Determine whether the asset receivables relating to uninsured accident and health plans on page 2 of the Annual or Quarterly Financial Statement have been netted against the liability on page 3 for amounts held under uninsured accident and health plans. One indication that these amounts have been netted would be if there was an uninsured receivable relating to uninsured accident and health plans (Page 2, Column 3, Line 17) without a liability for amounts held under uninsured accident and health plans (Page 3, Column 3, Line 22) or vice versa.
- Determine whether the disclosures been made in the Notes to Financial Statements regarding the possible uncollectability of amounts receivable under uninsured plans.
- Inquire of the Insurer:
  - Listing of plans administered by the insurer.
  - Aging schedule of receivables related to uninsured plans.
  - Amounts of any uncollectable receivables under uninsured plans that have been written off in the current period. Compare the write-offs to those of the prior reporting period, if any.
  - Request a copy of the I.D. card used by members covered under ASO and ASC arrangements to determine potential exposure to financial risk and compliance penalties.

Collectability of Health Care Receivables for Health Insurers

Health care receivables can include pharmaceutical rebate receivables, claim overpayment receivables, loans and advances to providers, capitation arrangement receivables, risk-sharing receivables and government insured plan receivables. Similar to other assets in general, each of the above types of health care receivables is individually unique and can carry its own risks to the health entity. Some of them carry a higher degree of risk because of the use of estimates in establishing them. Others carry a low level of risk because the accounting requirements only allow the receivable to be established in certain circumstances. However, ultimately each of the health care receivables can present the same kind of financial risks as uncollected premiums. Like uncollected premiums, the collectability of health care receivables should be monitored by the health entity, as it could become a source of future problems if write-offs of uncollectable receivables become material.

Procedures / Data

- Review and assess health care receivables for potential collectability issues.
    - Ratio of health care receivables to capital and surplus.
    - Amount due from any one debtor equal or exceed 10% of gross health care receivable.
    - Change in health care receivables increased from the prior year.
    - Ratio of non-admitted health care receivables to admitted health care receivables.

Additional Review Considerations

- Review amounts non-admitted and compare to prior years.
- Review capitation and other agreements with providers and hospitals and the level of receivables from these parties.
- Inquire of the insurer:
    - Explanation for the significant balance.
    - Listing of balances of debtors, which individually account for 10% or more of the balance of health care receivables and compare to a similar list from prior years.
    - Amounts of any uncollectable balances that have been written off in the current period. Compare the write-offs to those of the prior reporting period, if any.
    - Written procedures for monitoring and collecting uncollected premiums, including amounts already written off.
    - Inquire whether the insurer has factored or sold its health care receivables to a third party. Note whether the receivables were discounted in the transaction.

Collectability Risk of Recoverables for High-Deductible Policies for P/C Insurers

Large deductible programs for workers' compensation insurance marketplace create added risk. Credit quality and poor financial strength of a professional employer organization (PEO), for example, may result in future collectability risk, which may result in ongoing credit risk and future liquidity issues. Large deductible programs can be complex arrangements and depend on the employer's fulfillment of its obligation to reimburse all claims within the deductible. If the employer is unable to fulfill that obligation, the financial consequences to the employer could be catastrophic, and the employer's inability to pay could have a cascading impact on the financial health of the insurer. In order to manage this risk successfully, insurers and state insurance regulators must have a clear understanding of the nature and size of the insurer's exposure. Additionally, they must ensure that there are adequate measures in place to limit and mitigate the risk of the employer's failure to pay and ensure injured workers will receive benefits in compliance with state law. For further information and guidance on high-deductible workers' compensation insurance, refer to the *2016 Workers' Compensation Large Deductible Study*.

Additional Review Considerations

Gain an understanding of the materiality of any reserve credit that has been recorded and is recoverable, as well as the materiality, aging and collateral held on any deductible recoverables and unpaid balances.

- Review Annual Financial Statement, Notes to Financial Statements, Note #31 for exposure to high-deductible policies.
    - Determine the materiality of any reserve credit that has been recorded and is recoverable.
    - Determine the materiality, aging and collateral held on any deductible recoverables and unpaid balances.

ADDITIONAL PROCEDURES APPLICABLE TO CREDIT RISK

Investment Strategy

Consider requesting and reviewing a copy of the insurer's formal adopted investment plan. This should be evaluated to determine if the plan appears to result in investments that are appropriate for the insurer, based on the types of business written and its liquidity and cash flow needs and to determine whether the insurer appears to be adhering to its plan. For example, the insurer's plan for investing in non-investment grade bonds should be reviewed for guidelines for the quality of issues invested in and diversification standards pertaining to issuer, industry, duration, liquidity, and geographic location.

Two possible credit risks associated with Investment Stategy include:

- Investment strategy contemplates higher credit risk.
  - The insurer's investment strategy may not be structured to support its ongoing business plan, which could indicate the strategy enjoys higher credit, market and liquidity risks than are appropriate for the liabilities of the insurer and may lead to financial concerns in the future.
- Variance in actual to projected investment results.
  - The insurer's actual investment portfolio and/or portfolio performance may vary significantly from projections if the insurer is not adhering to the strategy in place (i.e., higher actual credit compared to the plan).

If concerns exist, request and review insurer's investment strategy outlined in the business plan for:

- Quality of issues invested in and diversification standards pertaining to issuer, industry, duration, liquidity, geographic location, and issues/sectors exposed to material climate change, transition, and asset devaluation risks.
- Expected rate of returns on investments (projected investment income) compared to actual results.
- Planned increases in investment types, sectors, markets, etc.
- Appropriateness of the investment plan for the liability structure of the insurer. (This may require a review of asset adequacy analysis for asset liability management (ALM) and discussion with the insurer's management to better understand their plan.).
- Upon review of the investment plan, compare the plan to actual results and determine if the insurer and its investment manager(s) appear to be adhering to the investment policies and guidelines in the investment plan.

Examination Findings

Consider a review of the recent examination report, summary review memorandum and communication with the examination staff to identify if any credit risk issues were discovered during the examination.

Identify any examination findings regarding credit risks associated with:

- Investment concentration.
- Exposure to riskier asset classes.
- Climate change, transition, and asset devaluation.
- Asset liability management.
- Adherence to investment policies and strategies.
- Investment management and use of and monitoring of external investment managers.

- Proper classification (i.e., authorized, unauthorized, certified) and calculation of reinsurance collateral and provision.

If outstanding issues are identified, perform follow-up procedures as necessary to address concerns.

NAIC Capital Markets Bureau Analytical Assistance

Consider requesting the NAIC's Capital Markets Bureau (CMB) to assist with investment portfolio or investment management agreement analysis. The CMB has different levels of analysis that can be arranged to assist the state.

Consider requesting the following analytical reviews:

- Review of the insurer's investment portfolio.
- Review of investment management agreements (IMA).

Third-Party Investment Advisors

Determine whether concerns exist regarding the use of third-party investment advisers. As investments and investment strategies grow in complexity, insurers may consider the use of unaffiliated third-party investment advisers to manage their investment strategy. Investment advisers may operate independently or as part of an investment company. Investment advisers and companies are subject to regulation by the U.S. Securities and Exchange Commission (SEC) and/or by the states in which they operate, generally based on the size of their business. In certain situations, insurers may use a broker-dealer for investment advice. Broker-dealers are subject to regulation by the Financial Industry Regulatory Authority (FINRA). Regardless, most broker dealers and investment advisers will register with the SEC and annually update a Form ADV–Uniform Application for Investment Adviser Registration and Report Form by Exempt Reporting Advisers, which provides extensive information about the nature of the organization's operations. To locate these forms, analysts can go to *https://adviserinfo.sec.gov* and perform a search based on the company name.

Key information provided on a Form ADV includes:

a. Regulatory agencies and states in which the adviser/broker is registered.
b. Information about the advisory business including size of operations and types of customers (Item 5).
c. Information about whether the company provides custodial services (Item 9).
d. Information about disciplinary action and/or criminal records (Item 11).
e. A report of the independent public accountant verifying compliance if the investment advisor also acts as a custodian.

It is important to note that the information provided on Form ADV is self-reported and is subject to limited regulatory oversight. However, the information may be valuable to analysts in assessing the suitability and capability of investment advisers providing advisory services to insurers. In addition, although not expressly prohibited (as discussed at e. above), it is a best practice for the insurer to choose a national bank, state bank, trust company or broker/dealer which participates in a clearing corporation, other than its investment manager/advisor, to hold its assets in custody to promote segregation of duties. See additional guidance on custodial expectations in Section 1.F – Outsourcing of Critical Functions of the NAIC's Financial Condition Examiners Handbook.

Analysts should consider any significant risks identified in the most recent risk-focused examination and whether any follow-up procedures were recommended by the examiner. The examiner may have performed steps to determine the following: whether the investment adviser is suitable for the role (including whether he/she is registered and in good standing with the SEC and/or state securities regulators); whether the investment advisory agreements contain appropriate provisions; whether the adviser is acting in accordance with the agreement; and whether management/board oversight of the investment adviser is sufficient for the relationships in place.

Analysts should determine if changes have occurred in the insurer's use of investment advisers that may prospectively impact the insurer's investment strategy and overall management of the investment portfolio. If changes have occurred analysts may consider asking the insurer for an explanation for the change in investment advisers and obtain a copy of the new adviser agreement to gain an understanding of the provisions including the advisor's authority, specific reference to compliance with the insurer's investment strategy and/or policy statements, as well as state investment laws; conflicts of interest; fiduciary responsibilities; fees; and the insurer's review of the adviser's performance. Refer to the *Financial Condition Examiners Handbook* for further guidance and see V. C. Domestic and/or Non-Lead State Analysis – Form D Procedures for additional guidance on reviewing affiliated investment management agreements.

Analysts can determine if the investment advisor is in good standing with the SEC. The SEC does not officially use the term "good standing;" however, for this analysis, the term is used to mean a firm that is registered as an investment adviser with the SEC and does not report disciplinary actions or criminal records in Item 11 of the Form ADV.

If the insurer uses an external asset manager and if investments on Schedule BA assets are invested in funds that are affiliated with the asset manager or are managed by that asset manager, analysts should consider several possible issues that may result from this scenario. A possible concern may exist when the asset manager is also managing other funds in addition to managing assets for the insurer and then invests the insurer's assets in those other funds that the asset manager manages. While those funds may be good investments, both in general and for the insurer, there are a few issues that may need to be considered. First is the potential for a conflict of interest if the asset manager is using the insurer's available funds to provide seed money or fund the manager's other funds. Second is if any concerns exist regarding the appropriateness of the fund for the insurer's investment portfolio and if the transactions would be considered on an arm's-length basis. Third is the understanding that the insurer may be paying overlapping fees as the insurer would pay the asset manager a fee for the investment and then also pay a fee within the fund investment. There may be similar concerns with other complex investments such as structured securities that are originated by the asset manager or one of its affiliates/related parties. The fees associated with these investments could be considered arms-length and appropriate but would require further review and potentially additional support or documentation to make that determination.

Assess and determine if any concerns exist regarding third party investment advisers and associated contractual arrangements.

- Review Annual Financial Statement, General Interrogatories, Part 1, #29.05 and determine if the insurer utilizes third party investment advisors, broker/dealer or individuals acting on behalf of the insurer with access to their investment accounts.

If "yes," consider the following procedures:

- Verify that all affiliated and unaffiliated investment advisors the analyst is aware of are disclosed in the interrogatory, whether primary or sub-advisors.
  - Verify that Investment Management Agreements required to be filed with the department have been filed and consider requesting copies of agreements that have not been filed with the department for review.
  - Gain an understanding of the types of investments that are being managed by each of the advisors/sub-advisors disclosed in the interrogatory.
- Review the results of the most recent financial examination work papers, follow-up and prospective risk information and the summary review memorandum provided by the examiners and determine if the examination identified any issues with regard to investment advisers and associated contractual arrangements that require follow-up analysis or communication with the insurer. If "yes," document the follow-up work performed.
- Compare Annual Financial Statement, General Interrogatories, Part 1, #29.05 for the current year to the prior year to determine if there have been any changes in advisors.
  - If there has been changes in advisors, consider obtaining an explanation for the change from the insurer.

- If there has been changes in advisors, consider obtaining a copy of the new investment advisor agreement and review it for appropriate provisions.
- Using the information reported in Annual Financial Statement, General Interrogatories, Part 1, #29.05, obtain and review SEC Form ADV (if available), to determine if the investment advisor is in good standing with the SEC. If not in good standing, contact the insurer to request an explanation.
- Determine if agreements with third party investment advisers are affiliated, have the appropriate Form D – Prior Notice of Transactions been filed and approved by the department. And note any concerns or follow-up recommended.
    - See additional guidance in V. C. Domestic and/or Non-Lead State Analysis – Form D Procedures for reviewing affiliated investment manager agreements.
- Request information from the insurer regarding the background and expertise in any complex or non-traditional assets (such as structured securities, mortgage loans, investment funds) of its investment advisors (in-house and/or contractual) and its analytical system capabilities. Determine whether the advisors and systems are adequate to allow the insurer to continuously monitor its investments.
- If the insurer uses an external asset manager, consider if there are any investments that may represent a potential conflict. Examples of this are: (1) if there are investments reported on Schedule BA that are funds that are affiliated/related with the asset manager or are managed by that asset manager, (2) structured securities in which the asset manager or an affiliate/related party had a role in originating, or (3) direct investments in the asset manager or any of its affiliates/related parties. If the external asset manager qualifies as a related party, utilize guidance provided in the "Related Party Exposure in the Investment Portfolio" section above to assist in this review. Consider the following issues:
    - If any potential conflicts of interest have been reviewed and formally approved by the Board or Investment Committee.
    - If the investment is appropriate for the insurer's portfolio and is arm's-length.
    - If the insurer is paying overlapping fees.

Inquire of the Insurer

Consider requesting additional information from the insurer if credit risk concerns exist in a specific area. The list provided are examples of types of information or explanations to be obtained that may assist in the analysis of credit risk for specific topics where concerns have been identified.

If concerns exist, consider requesting information from the insurer regarding:

- If management has adequately reviewed the investment portfolio and understands the yields, underlying collateral, cash flows and investment volatility.
- Any additional concentration by collateral type.
- Management's process for valuing securities so as to assist the analyst in assessing if the securities are valued appropriately.
- Management's intended use of certain riskier investments and purpose within the insurer's portfolio.
- Credit risk associated with sector concentration.
- If management has an appropriate level of knowledge and expertise with the type of securities being purchased/held.
- If the insurer has controls implemented to mitigate the risks associated with this investment type.
- Sources of liquidity, such as LOCs.

Own Risk and Solvency Assessment (ORSA)

Obtain and review the latest ORSA Summary Report for the insurer or insurance group (if available) to assist in identifying, assessing and addressing risks faced by the insurer.

If the insurer is required to file ORSA or part of a group that is required to file ORSA,

- Determine whether the ORSA Summary Report analysis conducted by the lead state indicates any credit risks that require further monitoring or follow-up.
- Determine whether the ORSA Summary Report Analysis conducted by the lead state indicates any mitigating strategies for existing or prospective credit risks.

Holding Company Analysis

Obtain and review the holding company analysis work completed by the lead state to assist in identifying, assessing and addressing risks that could impact the insurer.

- Determine whether the Holding Company Analysis conducted by the lead state indicates any credit risks affecting the insurer that require further monitoring or follow-up.
- Determine whether the Holding Company Analysis conducted by the lead state indicates any mitigating strategies for existing or prospective credit risks affecting the insurer.

Asset Liability Management (ALM)

Consider a review of assets in conjunction with a review of sufficiency of reserves.

- Determine whether the review of the Statement of Actuarial Opinion or other actuarial filings indicate any concerns regarding the adequacy of ALM and the sufficiency of assets to meet the business obligations of the insurer.
- If concerns are identified regarding overall liquidity of the asset portfolio, request a copy of the insurer's asset/liability matching policy and/or liquidity stress testing/scenario analysis.

QUARTERLY CREDIT RISK ASSESSMENT

The quarterly credit risk procedures are designed to identify the following.

Significant Investment Concentration by Asset Class

Determine whether the insurer's investment portfolio appears to be adequately diversified to avoid an undue concentration of investments by class, sector, type or issue.

<u>Procedures/Data</u>

- Review admitted asset classes compared to total net admitted assets (excluding separate accounts).
  - Preferred Stock
  - Non-Investment Grade Gonds
  - Mortgage Loans
  - Other Invested Assets (Schedule BA)
  - Aggregate Write-ins for Invested Assets
  - Investments in Affiliates
- Determine if the total book/adjusted carrying value net of collateral for derivative investments open as of current statement date greater than 10% of surplus. [Quarterly Financial Statement, Schedule DB – Part D – Section 1].

<u>Additional Procedures</u>

- Review the Percentage Distribution of Total Assets for significant shifts in the mix of investments owned during the past five quarters.
- Review Schedule B, Part 2 to identify any mortgage loans or additions made during the quarter that include material amounts of mortgage loans with interest overdue or in the process of foreclosure.

Increased Exposure to Possible Default or Volatility Risk by Asset Class

Determine whether the insurer has a significant portion of its assets invested, or has significantly increased its holdings since the prior year-end, in certain types of investments that tend to be riskier.

Procedures/Data

- Review and determine whether there are concerns due to the change in certain asset classes from the prior year-end.
  - Increase in non-investment grade bonds and non-investment grade short-term investments from the prior year-end, where such investments are material compared to cash and invested assets (L/H) or policyholder surplus (P/C), or capital and surplus (Health).
  - Increase in mortgage loans from prior year-end, where the ratio of total mortgage loans are material compared to cash and invested assets (L/H) or policyholder surplus (P/C), or capital and surplus (Health).
  - Increase in BA assets from prior year-end, where the ratio of BA assets is material compared to cash and invested assets (L/H) or policyholder surplus (P/C) or capital and surplus (Health).
  - Increase in aggregate write-ins from prior year-end, where the ratio of aggregate write-ins are material compared to cash and invested assets (L/H) or policyholder surplus (P/C) or capital and surplus (Health).
  - Increase in affiliated investments from the prior year-end, where the ratio affiliated investments are material compared to cash and invested assets (L/H) or policyholder surplus (P/C) or capital and surplus (Health).
  - [Life only] Review Schedule DB – Part D – Section 1. Increase in derivative investments where the ratio of potential exposure to counterparty exposure for derivative instruments to capital and surplus plus AVR is material.

Additional Procedures

- If the level of non-investment grade bonds is material, review Quarterly Financial, Schedule D – Part 1B and the Quarterly Financial Profile Report to assess and understand the composition of non-investment grade bonds:
  - Amount and/or percentage of bonds in each class 3, 4, 5 or 6.
  - Concentration by sector or issuer, including affiliates.
  - If bonds have been rated by a credit rating provider (CRP).
- For additional guidance on individual procedure steps, please see the corresponding annual procedures discussed above.

Collectabilty of Reinsurance Recoverables and Reinsurer Credit Quality

Procedures/Data

- Determine whether amounts recoverable (both paid and unpaid losses on claims and reserve credits) or amounts receivable from reinsurers are significant and collectable.
  - Reinsurance amounts recoverable on paid and unpaid losses on claims to capital and surplus [L/H, Health] or policyholder surplus (P/C).
  - Change in reinsurance recoverables/receivables from prior year-end where recoverables/receivables are material.
  - Provision for reinsurance to policyholder surplus (P/C).
  - Change in the provision for Reinsurance, where the provision is material (P/C).
  - Review Quarterly Financial Statement, [L/H or Health Schedule S; P/C Schedule F] and notate any new reinsurers added since the prior quarter.
  - Determine if there any agreements to release reinsurers from liability during the quarter. [P/C Quarterly Financial Statement, General Interrogatories, Part 2, #2].
  - Determine if there any cancellations of primary reinsurance contracts during the quarter. [P/C Quarterly Financial Statement, General Interrogatories, Part 2, #3.1 and #3.2].
  - Determine whether the liability for reinsurance in unauthorized and certified companies is significant.
    - Liability for reinsurance in unauthorized and certified companies.
    - Change in liability, reinsurance in unauthorized and certified companies.
    - Change in liability for reinsurance in unauthorized and certified companies

- Determine whether the insurer experienced any material transactions requiring the filing of Disclosure of Material transactions with the state of domicile as required by the Model Act. [Quarterly Financial Statement, General Interrogatories, Part, #1.1].
  - If "yes," determine whether the insurer failed to make the appropriate filing of Disclosure of Materiality Transactions with the state of domicile. [Quarterly Financial Statement, General Interrogatories, Part 1, #1.2].

Additional Procedures

- If amounts recoverable or amounts receivable from reinsurers are significant, and concerns exist, consider the following procedures:
  - Determine the current ratings of the new reinsurer from the major rating agencies and investigate significant changes during the past 12 months.
  - Obtain and review the Annual Audited Financial Report, Financial Statements, Annual Actuarial Opinion and U.S. Securities and Exchange Commission (SEC) Filings (if applicable) of the reinsurer for additional insight regarding collectability and credit quality of the reinsurer.
  - Review information about the reinsurer available from industry analysts and benchmark capital adequacy with top performers and peer groups.
  - Contact the domiciliary state to determine whether any regulatory actions are pending against the reinsurer. Also, review iSite+ data on the reinsurer (i.e., financial statements, Regulatory Information Retrieval System [RIRS] and Global Receivership Information Database [GRID]).
- For additional guidance on individual procedure steps, please see the corresponding annual procedures discussed above.

Collectability of Affiliated Receivables; Significant Payable to Affiliates

Procedures/Data

- Review the balance sheet asset receivable from parent, subsidiaries, and affiliates, as well as the liability payable to parent, subsidiaries, and affiliates to determine whether there are concerns with the level of affiliated receivables/payables.
  - Affiliated receivable or payable to capital and surplus [L/H, Health] or policyholder surplus (P/C).
  - Change in affiliated receivable or payable, where receivables or payables are material compared to capital and surplus [L/H, Health] or policyholder surplus (P/C).
  - Change in federal and foreign income tax recoverables where recoverables are material compared to total admitted assets (excluding separate accounts for L/H).

Additional Procedures

- Determine whether there were any indications that significant or unusual transactions involve an affiliate or other related party.
- If there are concerns regarding collectability of affiliated receivables, review Notes to the Financial Statements and other available information (e.g., Form D filings) for more information about the nature and timing of the receivable.
- For additional guidance on individual procedure steps, please see the corresponding annual procedures discussed above.
- Review the Operational Risk procedures on affiliated transactions.

Collectability of Uncollected Premium and Agents' Balances for P/C and Health Insurers

Procedures/Data

- Review and assess uncollected premiums and agents' balances for potential collectability issues.

- Ratio of uncollected premiums and agents' balances to policyholder surplus (P/C) or capital and surplus (Health).
- Change in uncollected premiums and agents' balances from the prior year-end.
- Change in non-admitted uncollected premiums from the prior year-end.

Additional Procedures

- For additional guidance on individual procedure steps, please see the corresponding annual procedures discussed above.

Collectability of Receivables Relating to Uninsured Plans for Health Insurers

Procedures/Data

- Ratio of receivables relating to uninsured plans to capital and surplus.
- Change in receivables relating to uninsured plans from prior year-end.

Collectability of Health Care Receivables for Health Insurers

Procedures/Data

- Ratio of health care receivables to capital and surplus.
- Change in health care receivables from the prior year-end.
- Change in non-admitted health care receivables.

Additional Procedures

For additional guidance on individual procedure steps, please see the corresponding annual procedures discussed above.

~~Credit Risk Assessment~~

Commented [Staff1]: Text highlighted in Yellow represents proposed revisions from referrals received. See notations.

Credit Risk: Amounts actually collected or collectible are less than those contractually due or payments are not remitted on a timely basis.

The ~~objective of~~ Credit Risk Assessment ~~analysis~~ is focused primarily on exposure to credit risk of investments and reinsurance receivables. ~~The following discussion of procedures provides suggested data, benchmarks and procedures analysts can consider in their review.~~ In analyzing credit risk, analysts may analyze specific types of investments and receivables held by insurers. Analysts' risk-focused assessment of credit risk should take into consideration the following areas (but not be limited to):

- Concentrations of investments in type and sector (i.e., ~~lack of~~ diversification).
- Materiality of high-risk or low-quality investments.
- Extensive use of reinsurance.
- Credit quality of reinsurers.
- Collectability of reinsurance receivables.
- Collectability of other receivables (e.g., intercompany receivables).
- Credit quality of affiliates and subsidiaries.
- Quality of collateral held on unauthorized or overdue authorized reinsurance.
- Strategies for mitigating credit risk (i.e., counterparty risk with derivatives and off-balance sheet transactions).
- Collectibility of u~~U~~ncollected premium and agents' balances.

~~Overview of Investments~~Derivatives:
Refer to IV.A. Supplemental Analysis Guidance – Financial Analysis and Reporting Considerations for general information and a primer on derivatives.

~~Discussion of Annual Procedures~~GENERAL GUIDANCE

~~Using the Repository~~

To assess ~~The~~ credit risk, ~~repository is a~~ consider the ~~list of possible quantitative and qualitative~~ procedures, ~~including specific~~ data elements, metrics and benchmarks in this chapter. ~~and procedures from which analysts may select to use in their review of credit risk.~~
The placement of procedures, metrics and data within credit risk is based on "best fit." Analysts should use their professional judgement in categorizing risks when documenting financial determinations of the analysis. For example, key insurance operations or lines of business may have related risks addressed in different risk categories. Therefore, analysts may need to review other risks in conjunction with credit risk.

In conducting your analysis, utilize available tools in iSite+ such as financial profile reports, dashboards, investment snapshots, jumpstart reports, and other industry aggregated analysis. Consider also external tools such as rating agency reports, industry reports, and publicly available insurer information.

Analysts are not expected to ~~respond~~ document every~~to all~~ procedure~~s~~, ~~data~~data~~,~~ or benchmark result~~s listed in the repository~~. Rather, analysts and supervisors should use their expertise, knowledge of the insurer and professional judgement to tailor the analysis to address the specific risks of the insurer and document ~~completion~~ the applicable details within~~of~~ the analysis. Results of credit risk analysis should be documented in Section III: Risk Assessment of the insurer. Documentation of the risk assessment analysis should be sufficiently robust to explain the risks and reflect the strengths and weaknesses of the insurer.

~~The repository is not an all-inclusive list of possible procedures. Therefore, risks identified for which no procedure~~

~~is available should be analyzed by the state insurance department based on the nature and scope of the risk.~~
~~In using procedures in the repository, a~~Analysts should ~~review the results in~~complete their credit risk assessment in conjunction with:

- A review of the Supervisory Plan and Insurer Profile Summary and the prior period analysis.
- Communication and/or coordination with other internal departments. ~~are a critical step in the overall Risk Assessment process and are a crucial consideration in the review of certain procedures in the repository.~~
- ~~Analysts should also consider t~~The insurer's corporate governance which includes the assessment of the risk environment facing the insurer in order to identify current or prospective solvency risks, oversight provided by the board of directors and the effectiveness of management, including the code of conduct established by the board.

~~The placement of the following data and procedures in the credit risk repository is based on "best fit." Analysts should use their professional judgement in categorizing risks when documenting results of the analysis. Key insurance operations or lines of business, for example, may have related risks addressed in different repositories. Therefore, analysts may need to review other repositories in conjunction with credit risk.~~
~~***ANALYSIS DOCUMENTATION:*** Results of credit risk analysis should be documented in Section III: Risk Assessment of the insurer. Documentation of the risk assessment analysis should be sufficiently robust to explain the risks and reflect the strengths and weaknesses of the insurer. Analysts are not expected to respond to procedures, data or benchmark results directly in the repository document.~~
The following is not an all-inclusive list of possible procedures, data, or metrics. Therefore, risks identified for which no procedure is available should be analyzed by the state insurance department based on the nature and scope of the risk.

ANNUAL CREDIT RISK ASSESSMENT~~Quantitative and Qualitative Data and Procedures~~

~~example risk components for use in the Risk Assessment and Insurer Profile Summary branded risk analysis section and a general discription of the risk component. Note that the risks listed are only examples and do not represent a complete list of all risks available for the credit risk category.~~

~~**Investment Portfolio Diversification**~~

~~***Property/Casualty #***~~	~~***Life/A&H/Fraternal #***~~	~~***Health #***~~
~~***1***~~	~~***1***~~	~~***1***~~

Significant Investment Concentration by Asset Class

~~The procedure assists analysts in d~~Determine~~ing~~ whether the insurer's investment portfolio appears to be adequately diversified to avoid an undue concentration of investments by asset type, duration or issuer.

~~The ratios of the v~~Various types of investments to total net admitted assets (excluding separate accounts) are a measure of the diversity of the insurer's investment portfolio by type of investment. The results of these ratios may also provide some indication of the insurer's liquidity. Ratios are included for most types of investments except for government and agency bonds and cash and short-term investments, which are generally very liquid and have low credit risk. In addition, the ratio of the investment in any one issuer to total net admitted assets (excluding separate accounts) is a measure of the diversity of the insurer's investment portfolio by issuer.

Procedures / Data

- Consider evaluating the following assets classes that may have credit default risk in comparison to total admitted assets to determine the level of concentration:
  - Industrial and miscellaneous bonds (unaffiliated)
  - Residential mortgaged-backed securities (RMBS), commercial mortgage-backed securities (CMBS) or other loan-backed and structured securities (LBaSS)

- Preferred stocks
- Mortgage loans
- Other invested assets (Schedule BA)
- Derivative exposure to any single Exchange, Counterparty or Central Exchange
- Collateral Loans [Life/A&H Insurers]
- Aggregate write-ins for invested assets
- Investments in affiliates, subsidiaries, and parent
- Any single investment (by issuer) in bonds, pefered stock, mortgages, or BA assets (excluding federal issuers and affiliated investments)

Additional ~~r~~Review ~~c~~Considerations

- Review the ~~P~~percentage ~~D~~distribution of ~~A~~assets ~~in the Financial Profile Report~~ for significant shifts in the mix of investments owned during the past five years.
- ~~Analysts should c~~Compare the insurer's distribution of cash and invested assets to industry averages and peer averages on iSite+ to determine significant deviations from the industry and peer averages. The comparison should focus on an appropriate peer group based on insurer type and asset size.
- Review of the Annual Supplemental Investment Risks Interrogatories to identify any unusual items or areas and determine whether the insurer's investment portfolio is adequately diversified ~~with the appropriate level of liquidity to meet cash flow requirements~~ to avoid significant aggregate credit risk.
- Perform sector analysis of Schedule D holdings with assistance of the NAIC Capital Markets Bureau if concerns exist that indicate a sector of the market may be experiencing financial distress that could result in credit risk to holders of bonds or stocks in that sector.
- If concerns exist regarding counterparty credit risk on derivatives, review Annual Financial Statement, Schedule DB, Part D to identify the counterparties and use available information (e.g., rating agency reports) to identify any concerns with the credit quality of the counterparty.
- Review the Legal Risk ~~Repository~~ Assessment to determine whether the insurer's investment portfolio is in compliance with the investment limitations and diversification requirements per the state's insurance laws.
- Inquire of the insurer:
  - Planned asset mix and diversification strategies.
  - How the insurer manages counterparty credit risk, including diversification risk of counterparties.

Default and Volatility of Bond Exposures

~~**Exposure to Non-Investment Grade Bonds**~~

~~*Property/Casualty #*~~	~~*Life/A&H/Fratrnal #*~~	~~*Health #*~~
~~*2*~~	~~*2*~~	~~*2*~~

The procedure assists analysts in dDetermine~~ing~~ whether concerns exist due to the level of investment in non-investment grade bonds. Bonds which have NAIC designations of 3, 4, 5 or 6 are considered non-investment grade bonds and represent a significantly higher credit or default risk to the insurer than do investments in investment-grade bonds. In addition, the prices of non-investment grade bonds are frequently more volatile than the prices of investment grade bonds which makes the price at which bonds are held an important consideration.

The risk of impairment of bonds or other assets may be indicated by deterioration in the credit quality which may result in other-than-temporary impairments impacting income and surplus. Investment grade bonds that have declined to a non-investment grade status may not recover lost value (bondholder default risk).

Procedures / Data

- ~~Analysts should d~~Distinguish between the different non-investment grade classes as the risks are materially different. Consider the level of exposure to non-investment grade bonds in comparison to policyholder surplus (P/C), to capital and surplus plus AVR (L/H) and to capital and suprlus (Health), to total bonds, or to total invested assets.
- Consider fluctuations in non-investment grade bond holdings by designation.~~Analysts should also pay attention to issuers that the rating agencies have on negative watch.~~
- Review Annual Financial Statement, Schedule D – Part 1A – Section 1 and compare the insurer's holdings of non-investment grade bonds to the limitations included in ~~Model #340 by NAIC designation.~~
- *Investments in Medium and Lower Grade Obligations Model Regulation* (#340) (or similar state law). Given the potential volatility in prices and that the main concern is risk of loss to capital, an important consideration is the price at which non-investment grade bonds are held. The NAIC's ~~has adopted the *Investments in Medium and Lower Grade Obligations Model Regulation* (#340).~~ Model #340 establishes limitations on the concentration of non-investment grade bonds because of concerns that changes in economic conditions and other market variables could adversely affect insurers having a high concentration of these types of bonds.
  - Review the amount of non-investment grade bonds by NAIC designation compared to total net admitted assets (excluding separate accounts) utilizing Model #340:
    - Aggregate amount of all bonds owned which have an NAIC rating of 3, 4, 5, or 6.
    - Aggregate amount of all bonds owned which have an NAIC rating of 4, 5, or 6.
    - Aggregate amount of all bonds owned which have an NAIC rating of 5, or 6.
    - Aggregate amount of all bonds owned which have an NAIC rating of 6.

Additional Review Considerations

~~Additional review considerations~~

- ~~Review Annual Financial Statement, Schedule D – Part 1A – Section 1 and compare the insurer's holdings of non-investment grade bonds to the limitations included in Model #340 by NAIC designation.~~
- If the level of non-investment grade bonds is material, review Annual Financial Statement, Schedule D Part 1A and Part 1, Jumpstart Reports (e.g., Bond Investment Designation Exception Report) and the Financial Profile Report and Dashboards to assess and understand the composition of non-investment grade bonds:
  - Amount and/or percentage of bonds in each class 3, 4, 5 or 6.
  - Fluctuations and shifts in concentrations by class; new purchases; downgrades or upgrades.
  - Concentration by sector or issuer, including affiliates.
  - Whether or not bonds have been rated by a credit rating provider (CRP) (e.g., Moody's Investors Service, Standard & Poor's, A.M. Best, or Fitch Ratings).
  - Issuers that the rating agencies have on negative watch.
- Inquire of the insurer:
  - Explanation of significant exposures.
  - Policies and strategy for investing in non-investment grade bonds. Determine if the insurer is adhering to those investment policies.
  - For the more significant non-investment grade bonds, consider requesting from the insurer audited financial statements and a rating agency report from a CRP for the issuer of the bonds to assess the issuer's current financial position and ability to repay its debt.

~~Exposure to Mortgage - and/or Asset-Backed Securities~~

~~*Property/Casualty #*~~	~~*Life/A&H/Fraternal #*~~	~~*Health #*~~
~~*3*~~	~~*3*~~	~~*3*~~

Borrower Default for RMBS, CMBS and LBaSS Securities,
Volatility of RMBS, CMBS, and LBaSS Securities, and
Prepayment Variability for RMBS

~~The procedure assists analysts in d~~Determin~~ing~~e whether concerns exist over borrower default risk due to the level of investments in residential mortgage-backed securities (RMBS), commercial mortgage-backed securities

(CMBS) and loan-backed and structured securities (LBaSS) or prepayment variability risk in RMBS. Lower credit quality of the borrowers (i.e., prime versus subprime) may result in higher risk of default, leading to credit losses in the event of a housing and/or commercial real estate market downturn.

Of the structured securities, RMBS can be among the most complex and volatile. RMBS convert a pool of mortgage loans into a series of securities that have expected maturities which vary significantly from the underlying pool as a result of slicing the pool into numerous tranches with different repayment characteristics. RMBS are often issued or backed by the U.S. government, and when they are, they carry very little credit risk. As a result, agency-backed RMBS have been designated category 1.

However, the credit rating does not consider the prepayment or interest rate risk inherent in the RMBS investment. Prepayment variability in RMBS could result in actual cash flows and investment yields to be materially different from expectations. If the underlying mortgage loans are repaid by the borrowers faster or slower than anticipated, the RMBS repayment streams will be affected and the expected durations will either contract or extend. Thus, the cash flows on these investments are much more unpredictable than those for more traditional bonds and the cash flows can be either more or less variable than for mortgage pass-through certificates. If the RMBS prepayments are significantly faster than anticipated, and the insurer had paid a large premium for the RMBS when it was acquired, the insurer could experience a significant loss on the investment even though the par value was received. In addition, cash flows on RMBS are harder to match with corresponding payments on policy liabilities which leads to the risk that prepayments may not be able to be reinvested in investments earning comparable yields in order to support the liability payment streams. When interest rates rise, prepayment will likely slow and~~, meaning that~~ the investors will be unable to take advantage of ~~the~~ higher rates.~~, and w~~When interest rates decline, prepayments will rise, forcing investors to reinvest at the lower rates which~~. This will affect~~ impacts the value of bonds o~~i~~n the secondary market.

Procedures / Data

- Review the following ratios to determine the level of concentration in RMBS, CMBS and LBaSS owned.
  - Ratio of all RMBS, CMBS and LBaSS to total net admitted assets.
  - Ratio of all RMBS, CMBS and LBaSS compared to policyholder surplus (P/C), or capital and surplus or capital and surplus [L/H or Health].
  - RMBS compared to total cash and invested assets, or to capital and surplus.
  - Any increasing trend in a material exposure from the prior year.

Additional Review Considerations

~~***ADDITIONAL REVIEW CONSIDERATIONS***~~

- Review the RMBS, CMBS and LBaSS securities categories in Annual Financial Statement, Schedule D – Part 1 for bonds with a book/adjusted carrying value (BACV) significantly in excess of par value~~,~~. ~~which~~This could result in a loss being realized if bond prepayments occur faster than anticipated.
- Review the RMBS, CMBS and LBaSS categories in Annual Financial Statement, Schedule D – Part 1 for bonds with an unusually high effective yield.
- ~~Analysts should also consider reviewing a listing of the effective yield on each of the insurer's RMBS, CMBS and LBaSS securities.~~ The effective yield on most debt securities is generally linked to its credit risk and duration. However, significant prepayment risk can also increase the effective yield.
- Review Annual Financial Statement, Schedule D, Part 1, and the Snapshot Investment Summary Report on iSite+ to assess exposure to agency versus non-agency RMBS, CMBS and LBaSS.
- ~~Consider requesting information from the insurer regarding estimated prepayment speeds on its RMBS. Several standardized forms of calculating the rate of prepayments of a mortgage security exist in the market. Historically, the constant prepayment rate (CPR) and the standard prepayment model of the Bond Market Association (PSA curve) are simple methods used to measure prepayments. Numerous other methods have evolved. Analysts should consider further analysis in those instances that prepayment risk appears high.~~

- Consider having the RMBS, CMBS and LBaSS modeled by an independent actuary as a part of an independent cash flow analysis.
- Inquire of the insurer:
  - ~~Consider requesting information from the insurer regarding e~~Estimated prepayment speeds on its RMBS. Several standardized forms of calculating the rate of prepayments of a mortgage security exist in the market. Historically, the constant prepayment rate (CPR) and the standard prepayment model of the Bond Market Association (PSA curve) are simple methods used to measure prepayments. Numerous other methods have evolved. Analysts should consider further analysis in those instances that prepayment risk appears high.
  - There are many different types of RMBS, each of which have different characteristics and inherent risks. Therefore, consider requesting information from the insurer regarding the percentage distribution and amounts of each type of RMBS, CMBS and LBaSS held; planned amortization class (PAC), support bonds, interest-only (IO) tranches, and principle-only (PO) tranches to evaluate the help evaluate the riskiness of the portfolio and the level of prepayment risk in the portfolio. IO bonds are particularly volatile.
  - Projected prepayment speeds on its RMBS portfolio and compare with historical prepayments, as well as the prepayment assumption at the time of purchase.

~~FOR LIFE INSURERS:~~ For Life/A&H Insurers:

- Consider a review of the insurer's life risk-based capital (RBC) formula or its Statement of Actuarial Opinion. The life RBC formula includes a C-3 Interest Rate Risk Component that charges insurer's for securities that have not been cash flow tested. The insurer is charged 0.5 times the excess of the statement value over the value of the security if all of the collateral was immediately repaid.
- Alternatively, or in addition ~~to this procedure~~, the Statement of Actuarial Opinion should be reviewed for comments regarding the modeling of the RMBS portfolio in the cash flow testing performed by the insurer.

- The rationale behind requesting information on these types of investments ~~outlined in the repository~~ is to provide analysts with some insight regarding the level of prepayment risk the insurer holds in its RMBS portfolio and the measurement and monitoring tools the insurer uses to manage this risk. ~~Parts f and g~~RBC C-3 Interest Rate Risk Component and the Actuarial Opinion cash flow testing ask the insurer to break down its RMBS portfolio by general definitional classes, each of which has its own relative level of prepayment and cash flow volatility risk. Individual insurers may use different measures and monitoring techniques. If an insurance company cannot supply this data with reasonable ease, analysts may want to look more closely at the management and monitoring systems in place for the RMBS portfolio.

Default, Volatility and Collateral Concentration of Structured Notes

Determine whether concerns exist due to the level of structured notes held by the insurer. If the amount is material compared to the the insurer's capital and surplus plus asset valuation reserve (AVR) (L/H), to policyholder surplus (P/C), or to capital and surplus (Health), the analyst should consider steps to gain a better understanding of the prospective risks of these investments and the insurer's level of investment expertise regarding these types of notes.

Structured notes are issuer bonds where the cash flows are based on a referenced asset and not the issuer credit. These notes differ from structured securities in that they do not have a related trust. Structured notes that are classified as mortgage-referenced securities are valued in accordance with *Statement of Statutory Accounting Principles (SSAP) 43R—Loan-Backed and Structured Securities* while all other structured notes are valued in accordance with *SSAP 86—Derivatives*. Some examples of mortgage-referenced securities include, secutiries issued by the Federal Home Loan Mortgage Corporation (FHLMC) (e.g., Structured Agency Credit Risk or STACR) and the Federal National Mortgage Association (FNMA). These mortgage referenced securities are not FE, and the Structured Securities Group (SSG) assigns their NAIC designation based upon modeling assumptions.

Risks related to structured notes include:

- Structured notes collateral concentration risk
  - Material investment in structured notes that may have collateral type concentration may result in concentration risk (lack of diversity) to the insurer's portfolio.
- Structured notes default
  - Structured notes may be subordinated in the overall transaction representing exposure to non-payment in event of default.
- Structured notes cash flow volatility risk (Refer to Market Risk)
  - Impact of the volatility of structured notes and the underlying asset on which its cash flows are based.

Procedures / Data

- Ratio of investments in structured notes to capital and surplus plus AVR (L/H), to policyholder surplus (P/C), or to capital and surplus (Health).

Additional Review Considerations

- Review the Annual Financial Statement, Schedule D – Part 1, to identify and understand the types of structured notes.
- Refer to any recent examination findings.
- Inquire of the insurer on such items as the structured note's use and investment strategy, the insurer's level of expertise with this type of security and controls the insurer has implemented to mitigate this risk.

Default Risk of Foreign Securities

Material exposure to foreign investments could result in credit losses if those investments are impacted by negative changes in geopolitical or foreign economic environments.

Procedures / Data

- Review the ratio of foreign bonds to total net admitted assets to determine the signficance of non-U.S. bond investments.

Additional Review Considerations

- If material and concerns exist, inquire of the insurer about the investment strategy for foreign investments and the nature of the foreign investments.
- Evaluate if the insurer is following the investment strategy as it pertains to these investments.

~~**Exposure to Mortgage Loans**~~

~~*Property/Casualty #*~~	~~*Life/A&H/Fraternal #*~~	~~*Health #*~~
4	*4*	*4*

Default or Volatility of Mortgage Loans

~~The procedure assists analysts in d~~Determin~~e~~ing whether concerns exist due to the level of expsoure or the quality of investment in mortgage loans, leading to possible default risk. The risk of impairment of mortgage loans may be indicated by deterioration in the credit quality which may result in other-than-temporary impairments impacting income and surplus. Mortgage loans may be at risk based on the volatility or impacts of economic changes in geographic regions.~~Most states restrict mortgage loan investments to first liens on property, with some states allowing second liens in instances where the insurer also owns the first lien.~~

Procedures / Data

- Consider the following metrics to assess materiality of exposure to mortgage loan default risk.
  - Ratio of mortgage loans to total net admitted assets.
  - Increase in exposure to mortgage loans from the prior year.

- Total mortgage loans compared to capital and surplus plus AVR (L/H), to policyholder surplus (P/C).~~,~~
- Ratio of troubled mortgage loans compared to capital and surplus plus AVR (L/H), to policyholder surplus (P/C) or to capital and surplus (Health).
- Ratio of commercial mortgages compared to total mortgages.

Additional Review Considerations

- Utilize postal code and property type information along with the city and state location information in Schedules A and B to identify geographic concentrations and to identify differences in volatility based on the property type and geographic location.
- Review Annual Financial Statement, Schedule B – Part 1 to determine the amount of each type of mortgage loan owned. Commercial mortgages have historically been riskier investments than farm mortgages and residential mortgages.
- If concerns exist, review Schedule B – Part 1, determine the amount of each type of mortgage loan owned.
- Determine whether any of the mortgage loans are to an officer, director, parent, subsidiary, or affiliate.
- Inquire of the insurer about increases by adjustment in book value/recored investment during the year.

Default of Second Lien Mortgage Loan

Most states restrict mortgage loan investments to first liens on property, with some states allowing second liens in instances where the insurer also owns the first lien. Second liens are more risky because, in the event of default, the holder of the first lien would be repaid out of any proceeds from the sale of the underlying property prior to the holder of the second lien.

~~For mortgage loans with interest overdue or in process of foreclosure, analysts should consider reviewing the year of last appraisal of the underlying land and buildings to determine whether updated appraisals should be required. For both real estate and mortgage loans, analysts should utilize postal code and property type information along with the city and state location information in Schedules A and B to identify geographic concentrations and to identify differences in volatility based on the property type and geographic location.~~

Procedures / Data

- Assess the materiality of exposure to second lein mortgage loans.
  - Amount of any "Other than first liens" compared to the total admitted mortgage loans [Annual Financial Statement, Assets (page 2)].

Inadequate Collateral for Mortgage Loan Risk

An ~~I~~important consideration~~s~~ in th~~i~~e~~s~~ analysis of mortgage loans ~~are~~ is the adjusted loan-to-value and debt service coverage ratio for each property owned, which are used in the determination of the mortgage's Commercial Mortgage Risk ~~c~~Category and are detailed in the RBC worksheet. Out-of-date appraisals may result in inaccurate valuation, resulting in an undervalued underlying collateral asset.

Procedures / Data

- ~~Compare the BACV of each loan to the value of the land and buildings mortgaged.~~ Review debt service coverage ratios and adjusted loan-to-values (i.e., book value/recorded investment of each loan compared to the value of the land and buildings mortgaged) of the individual mortgage loans to determine whether the mortgage loans are adequately collateralized.

Additional Review Considerations

- For mortgage loans with interest overdue or in process of foreclosure, review the date of the last appraisal or valuation (Schedule B – Part 1) to determine whether updated appraisals should be obtained.

~~***ADDITIONAL REVIEW CONSIDERATIONS FOR LIFE INSURERS***~~

- ~~Review Annual Financial Statement, Schedule B – Part 1 to determine the amount of each type of mortgage loan owned. Commercial mortgages have historically been riskier investments than farm mortgages and residential mortgages.~~

~~Compare the BACV of each loan to the value of the land and buildings mortgaged. Analysts should determine whether the mortgage loans are adequately collateralized and whether any of the mortgage loans are to officers, directors, or other affiliates of the insurer. Important considerations in this analysis are the adjusted loan-to-value and debt service coverage ratio for each property, which are used in the determination of the mortgage's CM category and are detailed in the RBC worksheet.~~

- ~~**For mortgage loans with interest overdue or in process of foreclosure, analysts should consider reviewing the year of last appraisal of the underlying land and buildings to determine whether updated appraisals should be required.**~~

~~**Exposure to Other Invested Assets (Schedule BA)**~~

~~*Property/Casualty #*~~	~~*Life/A&H/Fraternal #*~~	~~*Health #*~~
~~*5*~~	~~*5*~~	~~*5*~~

Default or Volatility of Other Invested Assets (Schedule BA)

~~The procedure assists analysts in d~~Determin~~ing~~e whether concerns exist due to the level of investment in other invested assets (Schedule BA). The types of investments included in Annual Financial Statement, Schedule BA include collateral loans, joint ventures and partnerships, oil and gas production and mineral rights. Joint ventures and partnerships typically involve real estate. These types of assets also tend to be fairly illiquid and may contain significant credit risk. BA assets often have complex investment strategies and unpredictable cash flows. The volatility of underlying assets (e.g., certain hedge funds and private equity funds) may result in underlying assets not being adequate. Credit risks for Schedule BA assets include:

- Credit quality of the investments that may result in impairment and default.
- Complexity of BA assets.
- Adequacy of collateral of BA assets.
- Volatility of cash flows.
- Portfolio volatility driven by economic changes on BA assets.

Procedures / Data

- Consider the following ratios to determine the exposure to BA Asset credit risk.
  - Ratio of Schedule BA assets to total net admitted assets.
  - Ratio of Schedule BA assets to policyholder surplus (P/C), to capital and surplus plus AVR (L/H), to capital and surplus (Health).
  - Increase in Schedule BA Assets from the prior year, where the investments in Schedule BA assets is material.

Additional Review Considerations~~***ADDITIONAL REVIEW CONSIDERATIONS***~~

Review Schedule BA to determine the amount and types of other invested assets owned and to determine whether they are properly categorized as other invested assets. Significant categories within Schedule BA are hedge funds and private equity funds. These and other investments in Schedule BA are characterized by complex strategies, lack of transparency for expected yields and cash flows, as well as high management fees.

- Review Annual Financial Statement, Schedule BA – Other Invested Assets Owned, to determine the amount and types of other invested assets owned and identify if the insurer's exposure to certain classes of BA assets are significant (e.g., hedge funds, private equity funds, etc.).
  - Determine whether concerns exist regarding the insurer's exposure to non-traditional investments, (i.e., hedge funds and private equity funds) as compared to capital and surplus and impact on liquidity.
  - Review the experience of the insurer with respect to investing in alternative investments such as hedge funds and private equity funds.

  - Obtain and review cash flow projections to ensure that the insurer understands the cash flow characteristics of such investments.
  - Perform procedures to test the accuracy of reporting for non-traditional investments.
  - Ensure that senior management and the Board of the insurer have signed off on non-traditional investments.
- Review Schedule BA to determine if a significant amount of BA assets have NAIC ratings of 3, 4, 5 or 6 or have a "Z" designation.
- Inquire of the insurer:
  - Investment strategy regarding investment in Schedule BA assets.
  - Request information necessary to determine the fair value of collateral to the amount loaned to ensure the loan is adequately collateralized.
  - See Market Risk and Liquidity Risk for other related inquiries.

~~**Exposure to Other Invested Assets (Schedule BA) – Value of Collateral Loans**~~

~~*Property/Casualty #*~~	~~*Life/A&H/Fraternal #*~~	~~*Health #*~~
~~*N/A*~~	~~*7*~~	~~*N/A*~~

Credit Quality of Assets Supporting Collateral Loans (Life/A&H Insurers)

The procedure assists analysts in determining whether concerns exist due to the level of investment in collateral loans. Analysts should review Annual Financial Statement, Schedule BA and Schedule DA. In most states, collateral loans are required to be secured or collateralized by assets which have a value in excess of the amount of the loan and which are considered admitted assets for an insurer.

Procedures / Data

- Review the following ratios to determine the level of concentration in collateral loans.
  - Ratio of collateral loans to total net admitted assets.
  - Ratio of collateral loans to capital and surplus plus AVR.

Additional Review Considerations ~~***ADDITIONAL REVIEW CONSIDERATIONS***~~

- Compare the fair value of the collateral to the amount loaned to determine whether the loan is adequately collateralized. In those instances where the underlying collateral is comprised of securities, analysts might consider verifying the rate used to obtain the fair value of the securities by referencing the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual).
- Review Annual Financial Statement, Schedule BA – Other Invested Assets Owned and Schedule DA – Short-term Investments, and perform the following for each such loan:
  - Determine whether the collateral for the loan is invested in a quality asset.
  - Determine whether the collateral loan is to an officer, director, parent, subsidiary, or affiliate.

~~**Invested Asset Exposure to Climate Change Risk**~~

~~*Property/Casualty #*~~	~~*Life/A&H/Fraternal #*~~	~~*Health #*~~
~~*6*~~	~~*6*~~	~~*6*~~

Impairment of Invested Assets Exposured to Climate Change and/or Transition Risk

~~The procedure assists analysts in i~~Identify~~ing~~ and assess~~ing~~ the potential exposure of the insurer's investment portfolio to the impact of material climate change and/or energy transition risks. Transition risks refer to stresses on certain investment holdings arising from the shifts in policy, consumer and business sentiment, or technologies associated with the changes necessary to limit climate change. A few examples of investment holdings and sectors generally subject to greater levels of transition risk include, oil/gas, transportation, heavy manufacturing, and agriculture. The insurer's investment portfolio is subject to prospective devaluation or impairment of the assets or changes in the asset return associated with its holdings of climate-affected assets.

Procedures / Data

~~In assessing an insurer's exposure to these risks, the analyst is encouraged to review information disclosed by the insurer in its responses to the NAIC's Climate Risk Disclosure Survey, U.S. Securities and Exchange Commission (SEC) filings, and/or the Own Risk and Solvency Assessment (ORSA) Summary Report filings. In addition, the analyst is encouraged to review the results of basic scenario analysis conducted by the NAIC using insurers' Annual Statement filings (U.S. Insurance Industry Climate Affected Investment Analysis) to identify potential concentrations in exposure.~~

- Review the information disclosed by the insurer in its responses to the NAIC's Climate Risk and Disclosure Survey (if available) on its exposure to material climate change/energy transition risk and related mitigation activity in this area.
- Review other relevant information provided in the Own Risk and Solvency Assessment (ORSA) Summary Report, and/or U.S. Securities and Exchange Commission (SEC) 10K or 10Q filings (if available) that discusses the insurer's exposure to material climate change/energy transition risk and related mitigation activity in this area.
- Review results of basic scenario analysis conducted by the NAIC using insurers' Annual Statement filings in the NAIC's U.S. Insurance Industry Climate Affected Investment Analysis to identify potential concentrations in insurer exposure.

Additional Review Considerations ~~***ADDITIONAL REVIEW CONSIDERATIONS***~~

- Review the insurer's investment policies and strategies to assess whether material climate change, transition and asset devaluation risk considerations have been appropriately implemented into the ~~company's~~ investment processes.
- Review the most recent examination report and summary review memorandum (SRM) for any findings regarding climate change/energy transition risks.
- If concerns exist, consider requesting information from the insurer regarding ~~how the insurer manages~~ its management of exposure to material climate change/energy transition risk, including how it identifies and estimates current and prospective exposures and the limits (if any) in place to avoid concentrations.

~~**Reinsurance Recoverable and Reinsurer Credit Quality**~~

~~***Property/Casualty #***~~	~~***Life/A&H/Fraternal #***~~	~~***Health #***~~
~~***7, 8, 9, 10***~~	~~***8, 9, 10***~~	~~***6, 7***~~

Collectability of Reinsurance Recoverables and Reinsurer Credit Quality

~~The procedure assists analysts in d~~Determin~~ing~~e whether reinsurance recoverables and receivables are significant and if so, whether the amounts involved are collectable. Reinsurance payments may be delayed or not be paid when due, resulting in cash flow mismatch.

Under a reinsurance contract, the primary insurer transfers or ~~"~~cedes~~"~~ to another insurer (~~the "~~reinsurer~~"~~) all or part of the ~~financial~~ risk ~~of loss for claims incurred under insurance policies sold to the policyholder~~. Reinsurance does not modify in any way the obligation of the ~~primary~~ direct insurer to pay policyholder claims. Only after ~~loss~~ claims have been paid can the ~~primary company~~direct insurer seek reimbursement from a reinsurer for its share of paid losses. As a result, evaluating the collectability of the recoverables and receivables, as well as the overall ~~credit-worthiness~~creditworthiness of the reinsurers~~,~~ is ~~a key concern~~important. Evaluating the collectability of reinsurance recoverables and receivables requires an understanding of the specific facts and circumstances relating to each reinsurer. ~~However, this evaluation is frequently oriented towards the type of reinsurer from whom the reinsurance was obtained.~~

Reinsurance is generally obtained from one of the following categories of insurers:

- Professional Reinsurers – The main business of professional reinsurers is assuming ~~reinsurance~~ premiums from non-affiliated insurers. ~~In general, the large and well-capitalized professional reinsurers will not pose a serious collectability concern.~~
- Reinsurance Departments of Primary Insurers – Many insurers assume reinsurance from non-affiliates, but also write ~~significant~~ business on a direct basis. These types of insurers may pose a larger collectability concern than professional reinsurers since the specialized reinsurance expertise may not be as strong.
- Alien Insurers – Reinsurers domiciled in another country may pose a ~~significant~~ collectability concern, if the reinsurer is domiciled in a jurisdiction with a solvency framework that may not be as strong as the U.S.

The fundamental issue involved with evaluating collectability is an assessment of the financial stability of the underlying reinsurers~~, and, if applicable, specific retrocessionaires involved throughout the chain of reinsurance~~. To evaluate the collectability of reinsurance recoverables, analysts should consider the need to collect as much financial information as ~~possible~~ necessary to evaluate the financial condition of~~about the~~ reinsurers assuming a material portion of risk, including various regulatory and governmental filings, rating agency reports, and financial analyses available from industry analysts.

A~~The~~ ceding insurer may not take credit for reinsurance recoverables in dispute with an affiliate~~e~~, which may result in ~~,~~a~~A final~~ recoverability issue. ~~may involve the treatment of disputed amounts.~~ Occasionally, a reinsurer will question whether an individual claim is covered under a reinsurance contract or may even attempt to nullify an entire treaty. A ceding insurer, depending on the individual facts, may or may not choose to continue to take credit for such disputed balances. ~~The ceding insurer may not take credit for reinsurance recoverables in dispute with an affiliate.~~

Collectability of Reinsurance Recoverables For Life/A&H Insurers

Procedures / Data

Review the following ratio results to determine whether amounts recoverable (paid and unpaid) or amounts receivable from reinsurers are significant and collectable.

- Reinsurance amounts recoverable on paid and unpaid losses on claims as a percentage of capital and surplus.
- Reserve credits as a percent of capital and surplus.
- Other amounts receivable under reinsurance contracts as a percentage of capital and surplus.
- Total amount of funds withheld for payment of losses by ceding companies as a percentage of capital and surplus.

Additional Review Considerations

- Review L/H Annual Financial Statement, Schedule S – Part 3 – Section 1 and Schedule S – Part 3 – Section 2 and determine if any unusual items were noted regarding the types of reinsurance or the concerns with specific reinsurers.
- If concerns exist, review the reinsurer's history of payments of recoverables and determine compliance with the NAIC *Life and Health Reinsurance Agreements Model Regulation* (#791) regarding quarterly settlements of payments due from reinsurers.
- Review the Annual Financial Statement, Notes to Financial Statements, Note #23 and determine if the insurer reported any items of concern regarding reinsurance balances.
- Determine if and assess any significant write-offs of reinsurance collectables that have occurred during the period.

- Verify by direct contact or confirmation that funds withheld for payment are valid and adequately segregated for payment of losses.
- Inquire of the Insurer the aging of reinsurance amounts payable (e.g., concerns with reinsurance related transactions that may require inquiry to the insurer)/receivable.

~~FOR PROPERTY/CASUALTY (P/C) INSURERS:~~Collectability of Reinsurance Recoverables For P/C Insurers

Review the following ratio results to determine whether amounts recoverable (paid and unpaid losses) or amounts receivable from reinsurers are material and collectable.

- Overdue paid losses and LAE reinsurance recoverables (91 days or more) to surplus.
- Total reinsurance recoverables from unauthorized reinsurers to surplus.
- Total reinsurance recoverables from alien reinsurers to surplus.
- Provision for overdue authorized and reciprocal jurisdiction reinsurance to authorized and reciprocal jurisdiction reinsurance recoverables on paid losses and LAE in dispute.
- Non-affiliated reinsurance recoverables on paid losses to surplus.
- Non-affiliated reinsurance recoverables on unpaid losses and LAE to surplus.
- Provision for unauthorized and certified reinsurance to total reinsurance recoverables from unauthorized and certified reinsurer.
- Total amount of funds withheld for payment of losses by ceding insurers to surplus.
- ~~.~~Unsecured reinsurance recoverables to surplus.
- Total reinsurance recoverables from any unauthorized or certified reinsurer to surplus.
- Total reinsurance recoverables from any alien reinsurer to surplus.
- Reinsurance recoverables in dispute to surplus.
- Maximum amount of return commissions due to reinsurers in the event of cancellation of all ceded reinsurance to surplus.
- Uncollectable reinsurance written off during the year to surplus.

Another important accounting ~~issue~~ concern for P/C insurers relates to the provision for reinsurance. Under statutory accounting practices, the insurer must establish a liability by a formula that considers:

- The amount of overdue reinsurance recoverable on paid losses due from authorized insurers and reciprocal jurisdictions, certified ~~reinsurers~~reinsurers, or unauthorized reinsurers~~;~~.
- Any collateral deficiency with respect to the amount of reinsurance recoverable on paid and unpaid losses due from certified reinsurers or unauthorized reinsurers.

Additional Review Considerations

- Review, by individual reinsurer, the amounts shown as collateral. Identify any unusual trends and determine the need to examine the underlying collateral in more detail to ensure its validity.
- Credit quality and poor financial strength of a reinsurer may result in future collectability risk, which may result in ongoing credit risk and future liquidity issues.
- If the insurer holds a material letter of credit (LOC) securing unauthorized and/or certified reinsurance recoverables, identify the amount of the LOC and the issuing bank. Identify any concerns and assess whether the collateral is at an adequate level.
- Review the Annual Financial Statement, Notes to Financial Statements, Note #23 and determine if there any relevant concerns regarding reinsurance balances.
- Review the reinsurer's history of recoverables and note on findings or concerns.
- Verify by direct contact or confirmation that funds withheld for payment are valid and adequately segregated for payment of losses.
- Inquire of the Insurer the aging of reinsurance amounts payables(e.g., concerns with reinsurance related transactions that may require inquiry to the insurer)/receivable.

Collectability of Reinsurance Recoverables For Health Insurers

Procedures / Data

Review the following ratio results to determine whether amounts recoverable (paid and unpaid) or amounts receivable from reinsurers are material and collectable.

- Reinsurance amounts recoverable as a percent of capital and surplus.
- Ceded premiums written to gross premiums written.
- Reserve credits as a percent of capital and surplus.

Additional Review Considerations

- Review Health Annual Financial Statement, Schedule S – Part 3 – Section 2 and determine if any unusual items were noted regarding the types of reinsurance and their relative significance, or the specific reinsurers involved.
- Review the Annual Financial Statement, Notes to Financial Statements, Note #23 and determine if the insurer reported any items of concern regarding reinsurance balances.
- Review the results of the Actuarial Opinion analysis and determine if any concerns were noted regarding the collectability of reinsurance recoverables.
- Review the reinsurer's history of recoverables and note any findings or concerns.
- Determine if and assess any significant write-offs of reinsurance collectables that have occurred during the period.
- Inquire of the Insurer the aging of reinsurance amounts payable/receivable.

Collectability of Reinsurance Recoverables due to Credit Quality of Retrocessionaires

Commented [Staff2]: Question for FASTWG: These procedures regarding retrocession exist in the P/C and Health repositories labeled as "pyramiding". Are analysts able to obtain information necessary to evaluate the credit quality of a retrocessionaire?

Additional Review Considerations

- Determine whether retrocession may be occurring that could cause significant collectability risk to the insurer if the retrocessionaire is of poor credit quality and unable to pay its obligations to the reinsurer.
  - For the five largest individual unauthorized reinsurers and the five largest individual certified reinsurers listed in the Annual Financial Statement, [P/C Schedule F – Part 3; L/H and Health Schedule S–Part 3] consider the need to obtain the reinsurer's Annual Financial Statement and determine the extent to which the reinsurer has engaged in retrocession agreements.
  - Determine if any unauthorized and/or certified reinsurers have ceded reserves greater than 50% of total gross reserves.
    - If so, consider reviewing the Annual Financial Statement of the more significant reinsurers or inquiring of the insurer, to evaluate the extent to which the reinsurers cede business to other reinsurers.
    - If significant collectability concerns surface as a result of these procedures, perform the appropriate procedures to evaluate collectability.
  - Consider discussing with the insurer and/or the reinsurer or retrocessionaire's domiciliary regulator any identified risks or concerns with credit quality of the reinsurer or retrocessionaire.

Credit Quality and Default of Reinsurer

Additional Review Considerations

Assess the credit quality and financial solvency of the reinsurers that the insurer cedes a material amount of business to or has material reinsurance recoverable due from. Credit quality and poor financial strength of a reinsurer may result in future collectability risk, which may result in ongoing credit risk and future liquidity issues.

- Determine the current ratings of the reinsurer from the major rating agencies and investigate significant changes during the past 12 months.

- Obtain and review the Audited Financial Report, Annual Financial Statement, Actuarial Opinion and U.S. Securities and Exchange (SEC) Filings (if applicable) of the reinsurer for additional insight regarding collectability and credit quality of the reinsurer.
- Review information about the reinsurer available from industry analysts and benchmark capital adequacy with top performers and peer groups.
- Contact the domiciliary state to determine whether any regulatory actions are pending against the reinsurer. Also, review iSite+ data on the reinsurer (i.e., financial statements, Regulatory Information Retrieval System [RIRS] and Global Receivership Information Database [GRID]).
- Determine whether the reinsurance transactions involved going "in and out" of treaties in such a manner that, in substance, the transactions are for financial reinsurance purposes (See Strategic Risk for more on financial reinsurance).
- Review [L/H and Health Schedule S – Part 4; P/C Schedule F] and determine if adequate levels of collateral (e.g., letters of credit) are maintained for unauthorized reinsurance and to secure outstanding losses.
- Review results of reinsurance Jumpstart Reports to determine if material differences exist between amounts reported on reinsurance schedules of the insurer compared to the ceding insurers.
    - If significant differences are noted, further investigate if the amounts appear to be due to timing and/or consider asking the insurer for aging of amounts payable/receivable.
- Review the individual authorized reinsurers listed in Schedule S – Part 3 – Section 2 and determine if any of the reinsurers generally known to enter into significant retrocession agreements.
- Inquire of the Insurer:
    - Request a copy of the insurer's A.M. Best Supplemental Ratings Questionnaire and review the reinsurance section for unusual items.
    - If concerns exist regarding the credit quality and financial solvency of an unauthorized reinsurer, request a copy of the reinsurance agreement(s), and confirm amounts included on Annual Financial Statement, [L/H and Health Schedule S – Part 4 - Reinsurance Ceded to Unauthorized Companies; P/C Schedule F – Part 3].

Reserve Credits Taken are Inappropriate (Life/A&H Insurers, Health)

Determine whether the insurer's accounting treatment for reinsurance is proper and in accordance with the *Annual Statement Instructions* to determine if the reserve credit taken is appropriate.

Procedures / Data

- Briefly scan the individual reinsurers listed in Annual Financial Statement, Schedule S – Part 3 – Section 1 - Reinsurance Ceded Life and Annuities and Schedule S – Part 3 – Section 2 - Reinsurance Ceded Accident and Health and Schedule S – Part 3 – Section 2 – Health and determine if any of the reinsurers classified as authorized appear to be improperly classified as such.
- Determine if there is a liability established for reinsurance with unauthorized reinsurers to the sum of reserve credits taken, paid and unpaid losses, and other debits material. [Annual Financial Statement, Schedule S – Part 4]

Additional Review Considerations

- Review Annual Financial Statement, Schedule S – Part 4. Determine if there are any concerns about the appropriateness of reinsurance credits taken.
- Note any concerns in the Statement of Actuarial Opinion regarding the insurer failing to properly establish a reserve relating to reinsurance assumed from another reinsurer for accident and health.
- Briefly scan the Annual Financial Statement pages relating to Assets; Liabilities, Surplus and Other Funds; and Summary of Operations and determine if any unusual items are noted relating to write-ins or significant changes or inconsistencies from prior years regarding reinsurance activities.
- Generate Examination Jumpstart analysis to determine whether ceding company credits are appropriately "mirrored" by the reinsurer, after considering the impact of normal timing delays.

- If the insurer holds a material LOC securing unauthorized reinsurance recoverables, identify the amount of the LOC, the issuing bank, and the rating of the bank.

~~**Affiliated Receivable or Payable**~~

~~*Property/Casualty #*~~	~~*Life/A&H/Fraternal #*~~	~~*Health #*~~
~~*10*~~	~~*11*~~	~~*11*~~

Collectiabilty of LOCs and Credit Quality of Issuing/Confirming Banks

Determine if there are credit quality or collectibilty concerns with banks that have issued or confirmed LOCs where the insurer is the beneficiary of a material LOC.

Additional Review Considerations

- Review Annual Financial Statement, General Interrogatories, Part 1, #15.1 and 15.2. Determine whether the beneficiary of an LOC that is unrelated to reinsurance where the issuing or confirming bank in not on the SVO Qualified U.S. Financial Institutions List.
- If "yes," identify and understand the issuing or confirming bank, the circumstances that can trigger the LOC and the amount.

Collectability of Affiliated Receivable or Payable

~~The procedure directs analysts to c~~Consider if any affiliated transactions have exposed the insurer to significant collectability risk. Credit quality and poor financial strength of an affiliate may result in future collectability risk, which may result in ongoing credit risk and future liquidity issues. For example, if the insurer is included in a consolidated federal income tax return and a significant asset for Federal Income Tax Recoverable is recorded on the financial statements of the insurer, analysts should closely review the financial statements of the parent to determine the parent's ability to repay the receivable. Structured settlements acquired from an affiliated life insurance company may also represent a collectability risk to the insurer. When the amounts of structured settlements are significant, analysts should review and understand the financial statements and payment ability of the life insurance affiliate.

Significant affiliated payables should be considered in relation to the extent of affiliated relationships, transactions~~,~~, and activities. Refer to Operational Risk for further consideration of significant amounts of affiliated payables.

Procedures / Data

- Review the balance sheet asset receivable from parent, subsidiaries, and affiliates, as well as the liability payable to parent, subsidiaries, and affiliates to determine whether there are concerns with the level of affiliated receivables or payables.
  - Affiliated receivable to capital and surplus (L/H, Health) or to policyholder surplus (P/C).
  - Affiliated payable to capital and surplus (L/H, Health) or to policyholder surplus (P/C).

Additional Review Considerations

- If there are concerns regarding collectability of affiliated receivables, review the Annual Financial Statement, Schedule Y – Part 2, Notes to the Financial Statements, Management's Discussion and Analysis (MD&A) and other available information (e.g., Form D filings) for more information about the nature and timing of the receivable.
- Review the Operations Risk Reference Guide for more procedures on affiliated transactions.

~~Other Receivables~~

~~*Property/Casualty #*~~	~~*Life/A&H/Fraternal #*~~	~~*Health #*~~
~~*11, 12*~~	~~*N/A*~~	~~*8, 9, 10*~~

~~The procedures assist analysts in reviewing receivable assets of an insurer that may have limited collectability.~~

Collectabilty/Default of Investments Involving Related Parties

Determine related party exposure in the investment portfolio and assess any related credit risk.

Related parties are entities that have common interests as a result of ownership, control, affiliation or by contract as definited in *SSAP No. 25—Affiliates and Other Related Parties* (SSAP No. 25). Refer to the *Insurance Holding Company System Model Act* (Model #440) and SSAP No. 25 for a broader definition of "affiliate," "related party" and "control".

Related party transactions are subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny.

The anlayst should utilize the tools available in iSite+ to identify if the insurer has a material exposure to investments involving related parties, either on an asset category basis or in aggregate, and by the related party designation noted below. If a material exposure exists, further assessment of the credit risk may be warranted. For example, what is the NAIC designation of investments involving related parties? Analysts may also consider the extent to which related parties are involved in securitizing or originating business for the insurer, and what differences may exist in how investments involving related parties are valued (market risk). If the role of the related party is that of a third-party advisor, factors to consider may include for example, the expertise of the related party advisor, any potential conflicts of interest, and if related parties are originating investments only for the insurer or also to the public, the latter being subject to SEC requirements.

Within the Annual Financial Statement investment Schedules B, BA, D, DA, DB, DL, and E (Part 2), all investments involving related parties must incude disclosure to ensure full transparency. This disclosure is in the column "Investments Involving Related Parites". It designates investments by the following roles:

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 another similar influential role.
5. The investment is identified as a 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.

Procedures / Data

- Review the Annual Financial Statement investment schedules, as disclosed in the column "Investments Involving Related Parties" and utilizing iSite+ tools, determine if the insurer has material related party exposures in its investment portfolio. This disclosure is included in:

- Schedule B~~.~~
- Schedule BA~~.~~
- Schedule D~~.~~
- Schedule DA~~.~~
- Schedule DB~~.~~
- Schedule DL~~.~~
- Schedule E, Part 2~~.~~

Consider exposure by asset class and in aggregate, and by the role of the related party in the investment as designed by the "Investments Involving Related Parties" disclosure.

- If concerns exist regarding a material related party exposure in the investment portfolio, assess the credit quality of those investments and assess any historical default experience.

Additional Review Considerations

If concerns exist regarding a material related party exposure in investment management or advisory services, consider the following.

- The analyst may consider utilizing suggested procedures in the "Additional Procedures" section below on third-party advisors, if applicable.
- In addition to the additional analysis procedures regarding third party investment advisors, consider the following:
  - Review the insurer's investment policy guidelines and determine whether the related party investments follow the guidelines and are in compliance with regulatory requirements.
  - Review whether the fee structure for asset management is fair, reasonable, and appropriately recognized as investment expenses.
  - If the related party asset manager also originates/securitizes investments held by the insurer, consider requesting additional information from the insurer to determine the following:
    - Whether the asset manager has adequate experience and knowledge in originating and managing the types of investments.
    - Whether the asset manager follows appropriate underwriting practices and applicable regulatory requirements in originating investments.
    - Whether the fee structures embedded in securities (if applicable) are fair, reasonable, and appropriately account for potential duplication of fees or conflicts of interest.

Collectability of Uncollected Premiums and Agents' Balances~~——~~ for P/C and Health Insurers

The asset for uncollected premiums and agents' balances in the course of collection includes amounts receivable that have been billed but have not yet been collected. Payments may be delayed or not be paid when due, resulting in a cash flow mismatch. Additionally, the credit quality and poor financial strength of an agent may result in future collectability risk, which may result in ongoing credit risk and future liquidity issues.

Agencies and brokers receive premium payments from insureds in a fiduciary capacity. Most states have laws that require the agent or producer to maintain trust accounts for the premiums they collect, which must be kept separate from their business operating funds. The premiums, net of commissions, are then remitted to the insurer or general agents from the accounts, leaving an audit trail.

Although agents are used by health entities, they are generally used more extensively with P/C insurers or even life insurers. Agents' balances are admitted to the extent that the assets conform to the requirements of *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts due from Agents and Brokers*, which also requires that premiums owed by agents should be reported net of commissions and are non-admitted under a 90-day rule. Remaining amounts that are determined to be uncollectable must be written off. Generally, if a contract with an agent permits offsetting, amounts payable to an agent may be offset against a receivable from that agent. Agents' balances carry credit risk and can have a material impact on the net income and capital and surplus of an insurer if the balances are significant. Significant or growing balances can also lead to liquidity problems if the insurer is unable to convert the receivables into cash to be used to pay claims.

Irrespective of the type of business written, inadequate systems and controls over the collection process can lead to uncollectable premiums. Uncollected premium balances on non-government business that are over 90 days due are non-admitted under SSAP No. 6. On all business, an evaluation of any remaining asset balance is required to determine any impairment. Amounts deemed uncollectable are required to be written off against income in the period the determination is made. These accounting requirements are designed to limit the total impact that collectability issues can have on an insurer at a given point in time.

Despite the efforts to mitigate the impact of uncollected premiums and agents' balances, write-offs and non-admitted unpaid premium assets can still have a material impact on the net income and capital and surplus of an insurer. These issues can lead to liquidity problems if the insurer is unable to convert the receivable into cash to be used to pay claims. Analysts should monitor the level of this asset as well as the change in the balance to help identify potential collection problems that can ultimately lead to significant decreases in surplus.

A material amount of uncollected agents' balances warrants further investigation to ensure that adequate controls are in place and that trust accounts are properly managed. An increase or trend of material non-admitted balances or write-offs may be a sign of mismanagement or misappropriation of trust accounts by the agency and should be investigated. Although this could occur at any agency, the risk is greater at affiliated agencies for the following reasons:

- The same owner controls both sides of the transaction.
- There is a lack of internal controls in relation to management overrides.
- Affiliated agency balances are often more material to small or medium-sized insurers.
- Affiliated agencies may not be subject to the same level of oversight as unaffiliated agencies.
- In the event of financial stress to the insurer or the agency, there may be an inherent conflict of interest.

If the analyst has concerns about the timely collection of agents' balances, the additional procedures related to premium trust accounts in the repository should be considered.

For Health Insurers~~FOR HEALTH INSURERS~~:
The collectability of amounts reported for uncollected premiums may also be impacted as a result of retroactive additions and deletions that are made subsequent to the date the group was invoiced. There may be a delay (sometimes several months) between the time that a large group adds a new covered employee or deletes an employee that is no longer covered and notice of the change is sent to the health entity. This length of the delay increases since the invoicing of the monthly premium is frequently in advance of the effective date of the coverage. This delay can result in the health entity reporting part of ~~a monthly~~the monthly billing as more than 90 days overdue and ultimately collecting less than what was billed. SSAP No. 6 states that if an installment premium is over 90 days due, the amount over ninety days due plus all future installments that have been recorded on that policy shall be non-admitted. However, for group accident and health contracts, a non-admitted *de minimus* over ninety-day balance would not cause future installments (i.e., monthly billed premiums on group accident & health) that have been recorded on that policy to also be non-admitted. The *de minimus* over 90-day balance itself would be non-admitted and the entire current balance would be subject to a collectability analysis.

The balance for uncollected ~~premium~~premiums may also result from amounts due from the Centers for Medicare and Medicaid Services or other government plans. Although coverage periods ~~on~~for this type of business are usually the same as comprehensive group business, the payment cycle can be much different due to the longer settlement periods experienced under government contracts. However, collectability of balances associated with government plans is usually not an issue. Because of this, the 90-day rule that is applied to other receivables is not applicable to receivables from these types of government plans.

Procedures / Data (P/C Insurers)

Review and assess uncollected premiums and agents' balances for potential collectability issues. Consider the following ratios.

- Ratio of uncollected premiums and agents' balances to surplus [IRIS ratio #10].
- Change in uncollected premiums and agents' balances from the prior year.
- Ratio of uncollected premiums to net premium income.
- Ratio of non-admitted uncollected premiums to total uncollected premiums.
- Net agents' balances and premium balances charged off and recovered to total uncollected agents' balances and premium balances.

Procedures / Data (Health Insurers)

Review and assess uncollected premiums and agents' balances for potential collectability issues. Consider the following ratios.

- Ratio of uncollected premiums and agents' balances to capital and surplus.
- Change in uncollected premiums and agents' balances from the prior year.
- Ratio of uncollected premiums to net premium income.
- Amount due from any one group or subscriber as percent of the uncollected premiums.
- Ratio of non-admitted uncollected premiums to total uncollected premiums.
- Net agents' balances and premium balances charged off and recovered to total uncollected agents' balances and premium balances.

Additional Review Considerations (P/C and Health Insurers)

- Review amounts non-admitted and compare to prior years.
- With respect to agents' balances, verify the creditworthiness of the agent.
- Inquire of the insurer:
  - Explanation for the significant balance.
  - Listing of balances of subscribers, which individually account for 10% or more of the premiums uncollected and compare to a similar list from prior years.
  - Amounts of any uncollectable balances that have been written off in the current period. Compare the write-offs to those of the prior reporting period, if any.
  - Written procedures for monitoring and collecting uncollected premiums, including amounts already written off.
  - If the insurer has factored or sold its uncollected premium balances to a third party, note whether the receivables were discounted in the transaction.
  - Concerns over uncollected agents' balances warrant further investigation to ensure that adequate controls are in place and that trust accounts are properly managed. An increase or trend of material non-admitted agents' balances or write-offs may be a sign of mismanagement or misappropriation of premium trust accounts by the agency. If there are concerns in this area, consider the following:
    - Request additional data/information from the insurer to identify the source(s) of the balances and the reason(s) for the non-admitted or charged-off amounts.
    - Request the insurer to provide a summary of the controls in place over agencies and ensure proper management and oversight of trust accounts.
    - Request monthly reports from the insurer.
  - Discuss concerns with the exam team, including whether a targeted exam is necessary.

Collectability of Uninsured Plan Receivables ~~(~~for Health Insurers~~)~~

Payments on uninsured plan receivables may be delayed or not be paid when due, resulting in a cash flow mismatch.

SSAP No. 47—Uninsured Plans defines uninsured accident and health plans, including HMO administered plans, as plans for which a health entity, as an administrator, performs administrative services such as claims processing for an at risk third party. Accordingly, the administrator does not issue an insurance policy. Two of the more common types of uninsured accident and health plans include an Administrative Services Only (ASO) plan or an Administrative Services Contract (ASC) plan.

Under uninsured plans, there is no underwriting risk to the health entity. The plan bears all of the-utilization risk, and there is no possibility of loss or liability to the administrator caused by claims incurred related to the plan. Although there is no underwriting risk on these types of plans, credit risk can still be an issue. Under these types of agreements, it is common for a receivable to be established for services performed by the health entity, and/or amounts due to the health entity for claims paid by the health entity on behalf of the uninsured plan. The credit risk varies on these types of plans because under an ASC plan, the health entity pays the claims directly from its own bank ~~account, and~~account and would seek reimbursement at a later date. In contrast, under an ASO plan, the claims are paid from a bank account owned and funded directly by the uninsured plan ~~sponsor, or~~sponsor or are paid by the health entity but only after receiving funds to cover the amount paid. Combination plans may also be administered which contain elements of both an uninsured and an insured plan. If the funds held for disbursement under the uninsured plans are inadequate to meet disbursement needs, the insurer may advance funds to cover such disbursements.

As a result of such advances, the receivable should be recorded as an asset. Liabilities can also result from administering this type of business. This type of liability would result from funds of the uninsured plans being held by the health entity for making plan disbursements. Generally, the asset for the receivable and the liability for funds held should not be netted unless individual receivables and payments meet the requirements of *SSAP No. 64—Offsetting and Netting of Assets and Liabilities*.

Expense risk can also result from uninsured plans. This risk results primarily from the health entity incurring more expenses to administer the business than reimbursed from the uninsured plan. Analysts should use the information in Annual Financial Statement, Notes to Financial Statements, Note #18 — Uninsured Plans, to better assess the business risk to which the health entity is exposed under its uninsured plans. Refer to Section IV.B. Supplemental Analysis Guidance – Notes to Financial Statements, for guidance on reviewing Note #18.

Procedures / Data

- Compare the ratio of ASO/ASC claim payments to total hospital and medical expenses plus ASO/ASC claim payments [Annual Financial Statement, Notes to Financial Statements, Note #18, Part A and Part B].
- Compare the ratio of reimbursements from uninsured plans to total expenses plus reimbursements from uninsured plans [Annual Financial Statement, Underwriting and Investment Exhibit – Part 3].
- Ratio of receivables relating to uninsured plans to capital and surplus.
- Change in uninsured receivable relating to uninsured accident and health plans.
- Non-admitted uninsured receivables relating to uninsured accident and health plans.

Additional Review Considerations

- Determine whether any concerns exist regarding the profitability of uninsured accident and health plans and the uninsured portion of partially insured plans for which the insurer serves as an Administrative Services Only (ASO) or an Administrative Services Contract (ASC) plan administrator. [Annual Financial Statement, Notes to Financial Statements, Note #18].
- Determine whether the insurer reported ASO and/or ASC amounts in its Risk–Based Capital (RBC) filing (worksheet XR021) and not reported receivables or assets related to uninsured accident and health plans on its Annual Financial Statement or vice versa.
- Evaluate the adequacy of funds held for the plans' claims and expenses.
- Evaluate the financial condition of the uninsured plans.

- Determine whether the asset receivables relating to uninsured accident and health plans on page 2 of the Annual or Quarterly Financial Statement have been netted against the liability on page 3 for amounts held under uninsured accident and health plans. One indication that these amounts have been netted would be if there was an uninsured receivable relating to uninsured accident and health plans (Page 2, Column 3, Line 17) without a liability for amounts held under uninsured accident and health plans (Page 3, Column 3, Line 22) or vice versa.
- Determine whether the disclosures been made in the Notes to Financial Statements regarding the possible uncollectability of amounts receivable under uninsured plans.
- Inquire of the Insurer:
  - Listing of plans administered by the insurer.
  - Aging schedule of receivables related to uninsured plans.
  - Amounts of any uncollectable receivables under uninsured plans that have been written off in the current period. Compare the write-offs to those of the prior reporting period, if any.
  - Request a copy of the I.D. card used by members covered under ASO and ASC arrangements to determine potential exposure to financial risk and compliance penalties.

Collectability of Health Care Receivables ~~(~~for Health Insurers~~)~~

Health care receivables can include pharmaceutical rebate receivables, claim overpayment receivables, loans and advances to providers, capitation arrangement receivables, risk-sharing receivables and government insured plan receivables. Similar to other assets in general, each of the above types of health care receivables is individually unique and can carry its own risks to the health entity. Some of them carry a higher degree of risk because of the use of estimates in establishing them. Others carry a low level of risk because the accounting requirements only allow the receivable to be established in certain circumstances. However, ultimately each of the health care receivables can present the same kind of financial risks as uncollected premiums. Like uncollected premiums, the collectability of health care receivables should be monitored by the health entity, as it could become a source of future problems if write-offs of uncollectable receivables become material.

Procedures / Data

- Review and assess health care receivables for potential collectability issues.
  - Ratio of health care receivables to capital and surplus.
  - Amount due from any one debtor equal or exceed 10% of gross health care receivable.
  - Change in health care receivables increased from the prior year.
  - Ratio of non-admitted health care receivables to admitted health care receivables.

Additional Review Considerations

- Review amounts non-admitted and compare to prior years.
- Review capitation and other agreements with providers and hospitals and the level of receivables from these parties.
- Inquire of the insurer:
  - Explanation for the significant balance.
  - Listing of balances of debtors, which individually account for 10% or more of the balance of health care receivables and compare to a similar list from prior years.
  - Amounts of any uncollectable balances that have been written off in the current period. Compare the write-offs to those of the prior reporting period, if any.
  - Written procedures for monitoring and collecting uncollected premiums, including amounts already written off.
  - Inquire whether the insurer has factored or sold its health care receivables to a third party. Note whether the receivables were discounted in the transaction.

Collectability Risk of ~~Exposure to~~Recoverables for High-Deductible Policies ~~(~~for P/C Insurers~~)~~

Large deductible programs for workers' compensation insurance marketplace create added risk. Credit quality and poor financial strength of a professional employer organization (PEO), for example, may result in future collectability risk, which may result in ongoing credit risk and future liquidity issues. Large deductible programs~~They~~ can be complex arrangements and depend on the employer's fulfillment of its obligation to reimburse all claims within the deductible. If the employer is unable to fulfill that obligation, the financial consequences to the employer could be catastrophic, and the employer's inability to pay could have a cascading impact on the financial health of the insurer. In order to manage this risk successfully, insurers and state insurance regulators must have a clear understanding of the nature and size of the insurer's exposure. Additionally, they must ensure that there are adequate measures in place to limit and mitigate the risk of the employer's failure to pay and ensure injured workers will receive benefits in compliance with state law. For further information and guidance on high-deductible workers' compensation insurance, refer to the *2016 Workers' Compensation Large Deductible Study*.

~~The procedures assist analysts in gaining some basic understanding of the materiality of any reserve credit that has been recorded and is recoverable, as well as the materiality, aging and collateral held on any deductible recoverables and unpaid balances.~~

Additional Review Considerations

Gain an understanding of the materiality of any reserve credit that has been recorded and is recoverable, as well as the materiality, aging and collateral held on any deductible recoverables and unpaid balances.

- Review Annual Financial Statement, Notes to Financial Statements, Note #31 for exposure to high-deductible policies.
    - Determine the materiality of any reserve credit that has been recorded and is recoverable.
    - Determine the materiality, aging and collateral held on any deductible recoverables and unpaid balances.

~~Investments Involving Related Parties~~

~~*Property/Casualty #*~~	~~*Life/A&H/Fraternal #*~~	~~*Health #*~~
~~*13*~~	~~*12*~~	~~*12*~~

~~This procedure assists analysts in determining related party exposure in the investment portfolio and assessing any related credit risk.~~

~~Related parties are entities that have common interests as a result of ownership, control, affiliation or by contract as definited in *SSAP No. 25—Affiliates and Other Related Parties* (SSAP No. 25). Refer to the *Insurance Holding Company System Model Act* (Model #440) and SSAP No. 25 for a broader definition of "affiliate," "related party" and "control".~~

~~Related party transactions are subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny.~~

~~The anlayst should utilize the tools available in iSite+ to identify if the insurer has a material exposure to investments involving related parties, either on an asset category basis or in aggregate, and by the related party designation noted below. If a material exposure exists, further assessment of the [credit, market, liquidity] risk may be warranted. For example, what is the NAIC designation of investments involving related parties? Analysts may also consider the extent to which related parties are involved in securitizing or originating business for the insurer, and what differences may exist in how investments involving related parties are valued. If the role of the related party is that of a third-party advisor, factors to consider may include for example, the expertise of the related party advisor, any potential conflicts of interest, and if related parties are originating investments only for the insurer or also to the public, the latter being subject to SEC requirements. The analyst may consider utilizing~~

~~suggested procedures in the "Additional Procedures" section of the repository on third-party advisors, if applicable.~~

~~Within the Annual Financial Statement investment Schedules B, BA, D, DA, DB, DL, and E (Part 2), all investments involving related parties must incude disclosure to ensure full transparency. This disclosure is in the column "Investments Involving Related Parites". It designates investments by the following roles:~~

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.~~

ADDITIONAL ~~ANALYSIS AND FOLLOW-UP~~ PROCEDURES APPLICABLE TO CREDIT RISK

~~INVESTMENT STRATEGY~~ Investment Strategy

~~directs analysts to c~~Consider requesting and reviewing a copy of the insurer's formal adopted investment plan. This should be evaluated to determine if the plan appears to result in investments that are appropriate for the insurer, based on the types of business written and its liquidity and cash flow needs and to determine whether the insurer appears to be adhering to its plan. For example, the insurer's plan for investing in non-investment grade bonds should be reviewed for guidelines for the quality of issues invested in and diversification standards pertaining to issuer, industry, duration, liquidity, and geographic location.

Two possible credit risks associated with Investment Stategy include:

- Investment strategy contemplates higher credit risk.
  - The insurer's investment strategy may not be structured to support its ongoing business plan, which could indicate the strategy enjoys higher credit, market and liquidity risks than are appropriate for the liabilities of the insurer and may lead to financial concerns in the future.
- Variance in actual to projected investment results.
  - The insurer's actual investment portfolio and/or portfolio performance may vary significantly from projections if the insurer is not adhering to the strategy in place (i.e., higher actual credit compared to the plan).

If concerns exist, request and review insurer's investment strategy outlined in the business plan for:

- Quality of issues invested in and diversification standards pertaining to issuer, industry, duration, liquidity, geographic location, and issues/sectors exposed to material climate change, transition, and asset devaluation risks.
- Expected rate of returns on investments (projected investment income) compared to actual results.
- Planned increases in investment types, sectors, markets, etc.

- Appropriateness of the investment plan for the liability structure of the insurer. (This may require a review of asset adequacy analysis for asset liability management (ALM) and discussion with the insurer's management to better understand their plan.).
- Upon review of the investment plan, compare the plan to actual results and determine if the insurer and its investment manager(s) appear to be adhering to the investment policies and guidelines in the investment plan.

Examination Findings

~~direct analsyts to c~~Consider a review of the recent examination report, summary review memorandum and communication with the examination staff to identify if any credit risk issues were discovered during the examination.

Identify any examination findings regarding credit risks associated with:
- Investment concentration.
- Exposure to riskier asset classes.
- Climate change, transition, and asset devaluation.
- Asset liability management.
- Adherence to investment policies and strategies.
- Investment management and use of and monitoring of external investment managers.
- Proper classification (i.e., authorized, unauthorized, certified) and calculation of reinsurance collateral and provision.

If outstanding issues are identified, perform follow-up procedures as necessary to address concerns.

NAIC Capital Markets Bureau Analytical Assistance

~~directs analysts to c~~Consider requesting the NAIC's Capital Markets Bureau (CMB) to assist with investment portfolio or investment management agreement analysis. The CMB has different levels of analysis that can be arranged to assist the state.

Consider requesting the following analytical reviews:
- Review of the insurer's investment portfolio.
- Review of investment management agreements (IMA).

Third-Party ~~INVESTMENT~~Investment Advisors

~~assist analysts in d~~Determine~~ing~~ whether concerns exist regarding the use of third-party investment advisers. As investments and investment strategies grow in complexity, insurers may consider the use of unaffiliated third-party investment advisers to manage their investment strategy. Investment advisers may operate independently or as part of an investment company. Investment advisers and companies are subject to regulation by the U.S. Securities and Exchange Commission (SEC) and/or by the states in which they operate, generally based on the size of their business. In certain situations, insurers may use a broker-dealer for investment advice. Broker-dealers are subject to regulation by the Financial Industry Regulatory Authority (FINRA). Regardless, most broker dealers and investment advisers will register with the SEC and annually update a Form ADV–Uniform Application for Investment Adviser Registration and Report Form by Exempt Reporting Advisers, which provides extensive information about the nature of the organization's operations. To locate these forms, analysts can go to *https://adviserinfo.sec.gov* and perform a search based on the company name.

Key information provided on a Form ADV includes:

a. Regulatory agencies and states in which the adviser/broker is registered.
b. Information about the advisory business including size of operations and types of customers (Item 5).
c. Information about whether the company provides custodial services (Item 9).

d. Information about disciplinary action and/or criminal records (Item 11).
e. A report of the independent public accountant verifying compliance if the investment advisor also acts as a custodian.

It is important to note that the information provided on Form ADV is self-reported and is subject to limited regulatory oversight. However, the information may be valuable to analysts in assessing the suitability and capability of investment advisers providing advisory services to insurers. In addition, although not expressly prohibited (as discussed at e. above), it is a best practice for the insurer to choose a national bank, state bank, trust company or broker/dealer which participates in a clearing corporation, other than its investment manager/advisor, to hold its assets in custody to promote segregation of duties. See additional guidance on custodial expectations in Section 1.F – Outsourcing of Critical Functions of the NAIC's Financial Condition Examiners Handbook.

Commented [Staff3]: RFSWG referral on IMAs in this section.

Analysts should consider any significant risks identified in the most recent risk-focused examination and whether any follow-up procedures were recommended by the examiner. The examiner may have performed steps to determine the following: whether the investment adviser is suitable for the role (including whether he/she is registered and in good standing with the SEC and/or state securities regulators); whether the investment advisory agreements contain appropriate provisions; whether the adviser is acting in accordance with the agreement; and whether management/board oversight of the investment adviser is sufficient for the relationships in place.

Analysts should determine if changes have occurred in the insurer's use of investment advisers that may prospectively impact the insurer's investment strategy and overall management of the investment portfolio. If changes have occurred analysts may consider asking the insurer for an explanation for the change in investment advisers and obtain a copy of the new adviser agreement to gain an understanding of the provisions including the advisor's authority, specific reference to compliance with the insurer's investment strategy and/or policy statements, as well as state investment laws; conflicts of interest; fiduciary responsibilities; fees; and the insurer's review of the adviser's performance. ~~(~~Refer to the *Financial Condition Examiners Handbook* for further guidance~~.)~~ and see V. C. Domestic and/or Non-Lead State Analysis – Form D Procedures for additional guidance on reviewing affiliated investment management agreements.

Analysts can determine if the investment advisor is in good standing with the SEC. The SEC does not officially use the term "good standing~~";~~;" however, for this analysis, the term is used to mean a firm that is registered as an investment adviser with the SEC and does not report disciplinary actions or criminal records in Item 11 of the Form ADV.

If the insurer uses an external asset manager and if investments on Schedule BA assets are invested in funds that are affiliated with the asset manager or are managed by that asset manager, analysts should consider several possible issues that may result from this scenario. A possible concern may exist when the asset manager is also managing other funds in addition to managing assets for the insurer and then invests the insurer's assets in those other funds that the asset manager manages. While those funds may be good investments, both in general and for the insurer, there are a few issues that may need to be considered. First is the potential for a conflict of interest if the asset manager is using the insurer's available funds to provide seed money or fund the manager's other funds. Second is if any concerns exist regarding the appropriateness of the fund for the insurer's investment portfolio and if the transactions would be considered on an arm's-length basis. Third is the understanding that the insurer may be paying ~~double~~ overlapping fees as the insurer would pay the asset manager a fee for the investment and then also pay a fee within the fund investment. There may be similar concerns with other complex investments such as structured securities that are originated by the asset manager or one of its affiliates/related parties. The fees associated with these investments could be considered arms-length and appropriate but would require further review and potentially additional support or documentation to make that determination.

Assess and determine if any concerns exist regarding third party investment advisers and associated contractual arrangements.

- Review Annual Financial Statement, General Interrogatories, Part 1, #29.05 and determine if the insurer utilizes third party investment advisors, broker/dealer or individuals acting on behalf of the insurer with access to their investment accounts.

If "yes," consider the following procedures:

- Verify that all affiliated and unaffiliated investment advisors the analyst is aware of are disclosed in the interrogatory, whether primary or sub-advisors.
  - Verify that Investment Management Agreements required to be filed with the department have been filed and consider requesting copies of agreements that have not been filed with the department for review.
  - Gain an understanding of the types of investments that are being managed by each of the advisors/sub-advisors disclosed in the interrogatory.
- Review the results of the most recent financial examination work papers, follow-up and prospective risk information and the summary review memorandum provided by the examiners and determine if the examination identified any issues with regard to investment advisers and associated contractual arrangements that require follow-up analysis or communication with the insurer. If "yes," document the follow-up work performed.
- Compare Annual Financial Statement, General Interrogatories, Part 1, #29.05 for the current year to the prior year to determine if there have been any changes in advisors.
  - If there has been changes in advisors, consider obtaining an explanation for the change from the insurer.
  - If there has been changes in advisors, consider obtaining a copy of the new investment advisor agreement and review it for appropriate provisions.
- Using the information reported in Annual Financial Statement, General Interrogatories, Part 1, #29.05, obtain and review SEC Form ADV (if available), to determine if the investment advisor is in good standing with the SEC. If not in good standing, contact the insurer to request an explanation.
- Determine if agreements with third party investment advisers are affiliated, have the appropriate Form D – Prior Notice of Transactions been filed and approved by the department. And note any concerns or follow-up recommended.
  - See additional guidance in V. C. Domestic and/or Non-Lead State Analysis – Form D Procedures for reviewing affiliated investment manager agreements.
- Request information from the insurer regarding the background and expertise in any complex or non-traditional assets (such as structured securities, mortgage loans, investment funds) of its investment advisors (in-house and/or contractual) and its analytical system capabilities. Determine whether the advisors and systems are adequate to allow the insurer to continuously monitor its investments.
- If the insurer uses an external asset manager, consider if there are any investments that may represent a potential conflict. Examples of this are: (1) if there are investments reported on Schedule BA that are funds that are affiliated/related with the asset manager or are managed by that asset manager, (2) structured securities in which the asset manager or an affiliate/related party had a role in originating, or (3) direct investments in the asset manager or any of its affiliates/related parties. If the external asset manager qualifies as a related party, utilize guidance provided in the "Related Party Exposure in the Investment Portfolio" section above to assist in this review. Consider the following issues:
  - If any potential conflicts of interest have been reviewed and formally approved by the Board or Investment Committee.~~.~~
  - If the investment is appropriate for the insurer's portfolio and is arm's-length.
  - If the insurer is paying overlapping fees.

Inquire of the Insurer

~~directs analysts to c~~Consider requesting additional information from the insurer if credit risk concerns exist in a specific area. The list provided are examples of types of information or explanations to be obtained that may assist in the analysis of credit risk for specific topics where concerns have been identified.

If concerns exist, consider requesting information from the insurer regarding:

- If management has adequately reviewed the investment portfolio and understands the yields, underlying collateral, cash flows and investment volatility.
- Any additional concentration by collateral type.
- Management's process for valuing securities so as to assist the analyst in assessing if the securities are valued appropriately.
- Management's intended use of certain riskier investments and purpose within the insurer's portfolio.
- Credit risk associated with sector concentration.
- If management has an appropriate level of knowledge and expertise with the type of securities being purchased/held.
- If the insurer has controls implemented to mitigate the risks associated with this investment type.
- Sources of liquidity, such as LOCs.

~~OWN RISK AND SOLVENCY ASSESSMENT (ORSA)~~ Own Risk and Solvency Assessment (ORSA)

~~directs analysts to o~~Obtain and review the latest ORSA Summary Report for the insurer or insurance group (if available) to assist in identifying, assessing and addressing risks faced by the insurer.

If the insurer is required to file ORSA or part of a group that is required to file ORSA,

- Determine whether the ORSA Summary Report analysis conducted by the lead state indicates any credit risks that require further monitoring or follow-up.
- Determine whether the ORSA Summary Report Analysis conducted by the lead state indicates any mitigating strategies for existing or prospective credit risks.

~~HOLDING COMPANY ANALYSIS~~ Holding Company Analysis

~~directs analysts to o~~Obtain and review the holding company analysis work completed by the lead state to assist in identifying, assessing and addressing risks that could impact the insurer.

- Determine whether the Holding Company Analysis conducted by the lead state indicates any credit risks affecting the insurer that require further monitoring or follow-up.
- Determine whether the Holding Company Analysis conducted by the lead state indicates any mitigating strategies for existing or prospective credit risks affecting the insurer.

Asset Liability Management (ALM)

Consider a review of assets in conjunction with a review of sufficiency of reserves.

- Determine whether the review of the Statement of Actuarial Opinion or other actuarial filings indicate any concerns regarding the adequacy of ALM and the sufficiency of assets to meet the business obligations of the insurer.
- If concerns are identified regarding overall liquidity of the asset portfolio, request a copy of the insurer's asset/liability matching policy and/or liquidity stress testing/scenario analysis.

~~Example Prospective Risk Considerations~~

~~The table provides analysts with example risk components for use in the Risk Assessment and Insurer Profile Summary branded risk analysis section and a general discription of the risk component. Note that the risks listed are only examples and do not represent a complete list of all risks available for the credit risk category.~~

~~DISCUSSION OF~~ QUARTERLY CREDIT RISK ASSESSMENT~~PROCEDURES~~

The ~~Q~~quarterly ~~C~~credit ~~R~~risk ~~Repository~~ procedures are designed to identify the following.

~~:~~Significant Investment Concentration by Asset Class

Determine ~~W~~whether the insurer's investment portfolio appears to be adequately diversified to avoid an undue concentration of investments by class, sector, type or issue.

Procedures/Data

- Review admitted asset classes compared to total net admitted assets (excluding separate accounts).
  - Preferred Stock
  - Non-Investment Grade Gonds
  - Mortgage Loans
  - Other Invested Assets (Schedule BA)
  - Aggregate Write-ins for Invested Assets
  - Investments in Affiliates
- Determine if the total book/adjusted carrying value net of collateral for derivative investments open as of current statement date greater than 10% of surplus. [Quarterly Financial Statement, Schedule DB – Part D – Section 1].

Additional Procedures

- Review the Percentage Distribution of Total Assets for significant shifts in the mix of investments owned during the past five quarters.
- Review Schedule B, Part 2 to identify any mortgage loans or additions made during the quarter that include material amounts of mortgage loans with interest overdue or in the process of foreclosure.

Increased Exposure to Possible Default or Volatility Risk by Asset Class

Determine ~~W~~whether the insurer has a significant portion of its assets invested, or has significantly increased its holdings since the prior year-end, in certain types of investments that tend to be riskier.

Procedures/Data

- Review and determine whether there are concerns due to the change in certain asset classes from the prior year-end.
  - Increase in non-investment grade bonds and non-investment grade short-term investments from the prior year-end, where such investments are material compared to cash and invested assets (L/H) or policyholder surplus (P/C), or capital and surplus (Health).
  - Increase in mortgage loans from prior year-end, where the ratio of total mortgage loans are material compared to cash and invested assets (L/H) or policyholder surplus (P/C), or capital and surplus (Health).
  - Increase in BA assets from prior year-end, where the ratio of BA assets is material compared to cash and invested assets (L/H) or policyholder surplus (P/C) or capital and surplus (Health).
  - Increase in aggregate write-ins from prior year-end, where the ratio of aggregate write-ins are material compared to cash and invested assets (L/H) or policyholder surplus (P/C) or capital and surplus (Health).
  - Increase in affiliated investments from the prior year-end, where the ratio affiliated investments are material compared to cash and invested assets (L/H) or policyholder surplus (P/C) or capital and surplus (Health).

- [Life only] Review Schedule DB – Part D – Section 1. Increase in derivative investments where the ratio of potential exposure to counterparty exposure for derivative instruments to capital and surplus plus AVR is material.

Additional Procedures

- If the level of non-investment grade bonds is material, review Quarterly Financial, Schedule D – Part 1B and the Quarterly Financial Profile Report to assess and understand the composition of non-investment grade bonds:
  - Amount and/or percentage of bonds in each class 3, 4, 5 or 6.
  - Concentration by sector or issuer, including affiliates.
  - If bonds have been rated by a credit rating provider (CRP).
- For additional guidance on individual procedure steps, please see the corresponding annual procedures discussed above.

~~Exposure to and/or changes in risk related to~~Collectabilty of ~~r~~Reinsurance ~~r~~Recoverables and Reinsurer Credit Quality

Procedures/Data

- Determine whether amounts recoverable (both paid and unpaid losses on claims and reserve credits) or amounts receivable from reinsurers are significant and collectable.
  - Reinsurance amounts recoverable on paid and unpaid losses on claims to capital and surplus [L/H, Health] or policyholder surplus (P/C).
  - Change in reinsurance recoverables/receivables from prior year-end where recoverables/receivables are material.
  - Provision for reinsurance to policyholder surplus (P/C).
  - Change in the provision for Reinsurance, where the provision is material (P/C).
  - Review Quarterly Financial Statement, [L/H or Health Schedule S; P/C Schedule F] and notate any new reinsurers added since the prior quarter.
  - Determine if there any agreements to release reinsurers from liability during the quarter. [P/C Quarterly Financial Statement, General Interrogatories, Part 2, #2].
  - Determine if there any cancellations of primary reinsurance contracts during the quarter. [P/C Quarterly Financial Statement, General Interrogatories, Part 2, #3.1 and #3.2].
  - Determine whether the liability for reinsurance in unauthorized and certified companies is significant.
    - Liability for reinsurance in unauthorized and certified companies.
    - Change in liability, reinsurance in unauthorized and certified companies.
    - Change in liability for reinsurance in unauthorized and certified companies
  - Determine whether the insurer experienced any material transactions requiring the filing of Disclosure of Material transactions with the state of domicile as required by the Model Act. [Quarterly Financial Statement, General Interrogatories, Part, #1.1].
    - If “yes,” determine whether the insurer failed to make the appropriate filing of Disclosure of Materiality Transactions with the state of domicile. [Quarterly Financial Statement, General Interrogatories, Part 1, #1.2].

Additional Procedures

- If amounts recoverable or amounts receivable from reinsurers are significant, and concerns exist, consider the following procedures:
  - Determine the current ratings of the new reinsurer from the major rating agencies and investigate significant changes during the past 12 months.

  - Obtain and review the Annual Audited Financial Report, Financial Statements, Annual Actuarial Opinion and U.S. Securities and Exchange Commission (SEC) Filings (if applicable) of the reinsurer for additional insight regarding collectability and credit quality of the reinsurer.
  - Review information about the reinsurer available from industry analysts and benchmark capital adequacy with top performers and peer groups.
  - Contact the domiciliary state to determine whether any regulatory actions are pending against the reinsurer. Also, review iSite+ data on the reinsurer (i.e., financial statements, Regulatory Information Retrieval System [RIRS] and Global Receivership Information Database [GRID]).
- For additional guidance on individual procedure steps, please see the corresponding annual procedures discussed above.

~~Exposure to and/or changes in risks related to a~~Collectability of Affiliated ~~r~~Receivables; Significant Payable to Affiliates

Procedures/Data
- Review the balance sheet asset receivable from parent, subsidiaries, and affiliates, as well as the liability payable to parent, subsidiaries, and affiliates to determine whether there are concerns with the level of affiliated receivables/payables.
  - Affiliated receivable or payable to capital and surplus [L/H, Health] or policyholder surplus (P/C).
  - Change in affiliated receivable or payable, where receivables or payables are material compared to capital and surplus [L/H, Health] or policyholder surplus (P/C).
  - Change in federal and foreign income tax recoverables where recoverables are material compared to total admitted assets (excluding separate accounts for L/H).

Additional Procedures
- Determine whether there were any indications that significant or unusual transactions involve an affiliate or other related party.
- If there are concerns regarding collectability of affiliated receivables, review Notes to the Financial Statements and other available information (e.g., Form D filings) for more information about the nature and timing of the receivable.
- For additional guidance on individual procedure steps, please see the corresponding annual procedures discussed above.
- Review the Operational Risk procedures on affiliated transactions.

~~Exposure to and/or changes in risks related to~~Collectability of ~~u~~Uncollected ~~p~~Premium and ~~a~~Agents' ~~b~~Balances for P/C and Health Insurers ~~and r~~

Procedures/Data
- Review and assess uncollected premiums and agents' balances for potential collectability issues.
  - Ratio of uncollected premiums and agents' balances to policyholder surplus (P/C) or capital and surplus (Health).
  - Change in uncollected premiums and agents' balances from the prior year-end.
  - Change in non-admitted uncollected premiums from the prior year-end.

Additional Procedures
- For additional guidance on individual procedure steps, please see the corresponding annual procedures discussed above.

Collectability of Receivables ~~r~~Relating to ~~u~~Uninsured ~~p~~Plans ~~and health care~~for Health Insurers

Procedures/Data

- Ratio of receivables relating to uninsured plans to capital and surplus.
- Change in receivables relating to uninsured plans from prior year-end.

Collectability of Health Care Receivables for Health Insurers

Procedures/Data

- Ratio of health care receivables to capital and surplus.
- Change in health care receivables from the prior year-end.
- Change in non-admitted health care receivables.

Additional Procedures

For additional guidance on in~~i~~dividual procedure steps, please see the corresponding annual procedures ~~dicussed~~discussed above.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

TO: Greg Chew (VA), Chair, Financial Analysis Solvency Tools (E) Working Group

FROM: Amy Malm, Chair, Risk-Focused Surveillance (E) Working Group

DATE: January 29, 2024

RE: Referral of Macroprudential (E) Working Group Considerations.

In 2022, the Risk-Focused Surveillance (E) Working Group received a referral from the Macroprudential (E) Working Group related to a list of 13 regulatory considerations that have emerged due to recent activities of insurance groups, including but not limited to those pursued by private equity owned insurers. These issues were referred to the Risk-Focused Surveillance (E) Working Group due to its ongoing work on affiliated service agreements, as well as its charge to develop consistency between analysis and examination guidance. While work is underway on several of the issues referred, the Risk-Focused Surveillance (E) Working Group feels that two of items referred are not directly related to affiliated services, nor do they necessitate consistency in analysis/exam guidance as they are primarily financial analyst considerations.

As such, the Risk-Focused Surveillance (E) Working Group is referring consideration of these issues and the development of guidance in these areas, if necessary, to the Financial Analysis Solvency Tools (E) Working Group for its consideration:

- Surplus Notes and appropriate interest rates given their special regulatory treatment, including whether floating rates are appropriate. If necessary, follow any Statutory Accounting Principles (E) Working Group projects related to this topic.
    - See the regulator discussion under Consideration 3 in the full text of the attached referral for additional information and context.

- 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. Items discussed include capital maintenance agreements, including the development of regulatory guidance for when it might be appropriate to request an agreement and ways to make them stronger.
    - See the regulator discussion under Consideration 4 in the full text of the attached referral for additional information and context.

Attached is the full text of the referral provided to the Risk-Focused Surveillance (E) Working Group to assist in understanding and evaluating these issues. If there are any questions regarding the proposed recommendations, please contact us or NAIC staff (Bruce Jenson at *bjenson@naic.org*) for clarification. Thank you for your consideration.

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

To: Amy Malm, Risk-Focused Surveillance (E) Working Group Chair and

Justin Schrader, Risk-Focused Surveillance (E) Working Group Vice Chair

From: Marlene Caride, Commissioner, Financial Stability (E) Task Force Chair and

Justin Schrader, Macroprudential (E) Working Group Chair

CC: NAIC Support Staff: Bruce Jenson/Jane Koenigsman

Date: July 21, 2022

Re: Referral from the Plan for the List of MWG Considerations

The NAIC Macroprudential (E) Working Group (MWG) of the Financial Stability (E) Task Force (FSTF) was charged with coordinating the various NAIC activities related to private equity (PE) owned insurers. As an initial step, the MWG developed a list of 13 regulatory considerations. These considerations are frequently referenced as private equity (PE) concerns, but the Working Group developed the list with an activities-based frame of mind, recognizing that any ownership type and/or corporate structure could participate in these activities, including but not limited to PE owned insurers. The MWG members discussed detailed elements of the considerations and potential regulatory work, including explicit reference to the 2013 guidance added to the NAIC Financial Analysis Handbook for Form A reviews when a private equity owner was involved, and interested parties added useful comments to these during an exposure period. The MWG and FSTF adopted a final plan for addressing each of the 13 considerations, including many referrals to other NAIC committee groups.

The Financial Condition E Committee adopted this plan with no changes made during its virtual meeting on July 21, 2022. NAIC staff support drafted this referral letter to accomplish the actions captured in the adopted plan. It is unlikely any further modifications will occur to the adopted plan when it is considered for adoption by the full Plenary, but it is a possibility. Please begin work to address these referrals, recognizing the adoption by Plenary is still outstanding.

Each MWG consideration referred to your group is listed below. The summarized notes from the MWG regulator-only discussions follow the consideration in blue font and any interested party comments are also provided in purple font. Please consider these discussion points and comments in addition to your own discussion ideas when developing proposals to address the MWG consideration.

NAIC staff support for the MWG will follow the work your group performs and summarize your activities for reporting up to the FSTF. If you have any questions or need further direction, please contact Todd Sells (tsells@naic.org).

MWG Consideration Items Referred:

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.

Risk & Regulatory Consulting (RRC) Comment: "With respect to an Investment Management Agreement, RRC encourages an approach that includes a thorough review of the IMA to ensure it is fair and reasonable to the insurer. In addition to the specific items noted for consideration:

- ♣ Are there detailed and reasonable investment guidelines?
- ♣ Is there sufficient expertise at the insurer and on the insurer's Board to properly assess the performance and compliance of the investment manager?
- ♣ Is the investment manager registered as such under the Investment Advisers Act of 1940, and recognizes the standard of care as a fiduciary?

AIC Comments on "Conflict of Interest, Fees, and Termination" (3 individual comments):

Conflict of Interest

As a general matter, the terms of a contractual agreement should not be viewed as giving rise to a conflict of interest when the agreement is negotiated on an arm's length basis. Notwithstanding the foregoing, current law provides an established process to address potential conflicts (for example, requirements to appoint independent directors and traditional corporate law processes to ensure fairness and, under certain circumstances, review of transactions by regulators pursuant to Form D filings). Accordingly, investments sourced and allocated by alternative asset managers on behalf of insurance company clients should not, absent other factors, be viewed as presenting a potential conflict of interest, particularly where insurers retain full control over asset allocation (for example, insurers retain control over the asset classes in which they invest, as well as the amounts and periods of time over which such asset exposure is achieved).

Fees

Importantly, as an initial consideration, any fees paid to investment managers cannot be considered in isolation, rather they should be considered on a "net" basis – i.e., on the basis of total return (after fees are taken into account). Sophisticated institutional investors (including insurers) have a successful history of investing in a range of strategies despite certain investment products generally having higher fees than other available investment opportunities. On a net basis, private equity has consistently outperformed more traditional asset classes such as publicly traded stocks and public mutual funds8 Net-of-fees private debt funds have also consistently outperformed bond and equity market benchmarks.9 Insurers continue to recognize the value of investment opportunities that outperform when considered on a net basis.10 This approach has enabled the consistent delivery of industry leading investment results, which ultimately leads to a high level of financial strength.

Termination

Asset managers often dedicate extensive resources at the outset of a new arrangement in support of managing an insurer's general account assets (e.g., dedicating or reassigning existing personnel, hiring new employees, investing in information technology systems, expanding office space, further enhancing compliance and regulatory processes). As such, and because, in our experience, insurers have the right to terminate their investment management agreements (e.g., upon 30 days' notice), the desire for external asset managers to seek contractual protections (subject to arms' length negotiations) should an insurer decide to terminate the arrangement earlier than was originally anticipated by the parties is entirely appropriate.

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.

For Considerations 3 and 4 above (and for the FYI Consideration 5 below):

RRC Comment: In a Form A transaction, whether the owner of the insurer is a PE fund or another type of investor, expectations and structures behind insurer ownership may have changed. Because of that, RRC believes that the stipulations, either limited time or continuing, should protect against adverse policyholder outcomes resulting from that change in dynamic.

- ♣ The regulatory expectation is that owners of insurers should have a long, if not indefinite, time horizon. It is not uncommon for PE funds in general and other similar investment vehicles to have a limited time frame because they are specifically structured investment vehicles such as limited partnerships. For example, requiring that limited partnerships should not have a specific end date would bring that ownership vehicle into line with regulatory expectations.
- ♣ While there are typically no guarantees of additional funding in any ownership situation, having a structure that allows for backstop capital in the event that a need arises should be considered. This could be achieved through a parental guarantee or a capital maintenance agreement.
- ♣ With regards to dividends, even if dividends are permitted, it may be advisable to Memo 2 structure a claw back period. This could be effectuated with allowing dividends to the limited partnership structure but requiring that the funds not be paid out to the partners for some period of time to ensure that the availability is not short-lived.
- ♣ In a limited partnership structure, the limited partners may be considered passive investors and arguably should not be subject to the typical expectations of owners. However, additional understanding and restrictions on the interest of the general partner would be appropriate.
- ♣ In the event that the Form A includes transfer of business to offshore entities, requiring continued maintenance of capital levels similar to those in place prior to the transaction, and ongoing reporting to the U.S. regulator that is in line with the Statutory reporting framework, to ensure that there are no adverse implications to policyholders.
- ♣ Ensuring that corporate governance appropriately balances the desire for strong returns with the need to protect policyholders. For example, the Board and senior management should include members with appropriate background and knowledge of insurance laws and operations. In addition, risk and compliance functions should have appropriate reporting and communication lines to the Board.

- Policyholder non-guaranteed elements, such as credited rates and dividends, should not be inappropriately reduced from existing levels.

The following MWG Considerations were not referred to the Risk-Focused Surveillance (E) Working Group, but the regulator discussions either considered such a referral or mentioned work already underway at and/or assigned to the Risk-Focused Surveillance (E) Working Group in the above referrals.

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).

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.)

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.

As an FYI for Considerations 7 and 9 above:

RRC Comments on "collateralized loan obligations (CLOs) as a source of concern and therefore a focus for additional disclosure. "While there has been a continuing level of concern about CLOs in general, RRC encourages the working group to take a broader view as well. As a general matter, investments in CLOs are at least subject to disclosure and conflicts of interest standards under various securities laws and regulations. On the other hand, there are other potentially problematic investments that do not benefit from that regulatory oversight.

- ♣ Private funds – Some of the issues noted with respect to concerns about overlapping interests in CLOs may also be prevalent in various kinds of funds, especially privately placed funds that are reported on Schedule BA. Such investment vehicles may have significant areas that have the potential for a conflict of interest that would not be captured by securities laws. Such investment vehicles may also include substantial management fees for management of the fund.

- Collateral Loans – The U.S. insurance industry's reported exposure to Collateral Loans that are reported on Schedule BA has grown substantially in the last ten years. In addition to the same potential conflicts, it may be appropriate to revisit valuation and reporting guidance.

Surplus Notes Text in FAH

provides underwriting capacity and allows an insurer to expand its premium writings. The gross and net writings leverage ratios (P&C, A&H) measure the extent to which an insurer utilizes its underwriting capacity. High ratio results may indicate that an insurer is excessively leveraged and lacks sufficient surplus to finance the business currently being written.

The components of surplus can include common capital stock, preferred capital stock, gross paid-in and contributed surplus, surplus notes, unassigned funds (or retained earnings), and special surplus funds (usually established through an appropriation of unassigned funds). Each state has, by statute, established a minimum required amount of surplus for insurers. In some states, these minimum amounts are based on the lines of business written, while in other states the minimum amounts are based on the type of insurer. In addition, the RBC requirements must also be met.

Insurers may issue capital or surplus notes as a source of financing growth opportunities or to support current operations. Surplus notes (sometimes referred to as "surplus debentures" or "contribution certificates") have the characteristics of both debt and equity. Surplus notes resemble debt in that they are repayable with interest and sometimes, depending on the requirements of the domiciliary state insurance department, include maturity dates and/or repayment schedules. However, key provisions of the surplus notes make them tantamount to equity. These provisions include approval requirements as to form and content and the requirement that interest may be paid, and principal may be repaid only with the prior approval of the domiciliary state insurance department. SSAP No. 41R - *Surplus Notes* requires that interest on surplus notes is to be reported as an expense and a liability only after payment has been approved. Accrued interest that has not been approved for payment should be reflected in the Notes to Financial Statements. Provided that the domiciliary state insurance department has approved the form and content of the surplus notes and has approval authority over the payment of interest and repayment of principal, surplus notes are considered to be surplus and not debt. The proceeds from the issuance of surplus notes must be in the form of cash, cash equivalents, or other assets having a readily determinable value satisfactory to the domiciliary state insurance department. Information regarding surplus notes must be reported in the Annual Financial Statement, Notes to Financial Statements #13.

Insurers may also issue capital notes, which are reported as a liability by the insurer, and are therefore treated as debt instruments (although in liquidation rank with surplus notes) and are subordinate to the claims of policyholders, claimants, and general creditors. Capital notes are included in the insurer's total adjusted capital for RBC calculations. Like surplus notes, capital notes are repayable with interest and include maturity dates and/or repayment schedules. However, payment of interest and repayment of principal generally do not require regulatory approval. When total adjusted capital falls below certain levels or if other adverse conditions exist, capital note payments may be required to be deferred. While deferred, any interest on the capital note should not be reported as an expense or the accrual as a liability, but instead should be reflected in the Annual Financial Statement, Notes to Financial Statements #11, similar to surplus note interest payments that have not been

Capital Maintenance Agreement Text in FAH

analysts in identifying significant amounts of capital and surplus notes and write-ins for special and other than special surplus funds, as well as other activities during the year related to capital and surplus notes.

Procedure #11X assists analysts in assessing current and prospective risk related to existing Parental Guarantees and/or Capital Maintenance agreements.

Parental Guarantees and Capital Maintenance Agreements are commitments aimed at providing assurance that the insurer will be able to meet minimum financial obligations if financial or liquidity issues arise. These documents should be carefully reviewed along with the financial background of the entity required to fund the guarantee or agreement. Analysts may also inquire of the insurer if a contingency plan is in place in the event the parental guarantee or capital maintenance agreement is not honored.

Review and assess any parental guarantees, capital maintenance agreements or other commitments in place and determine if concerns exist regarding financial support or failures to act on these commitments. Analysts should thoroughly review the terms related to the agreement to gain a clear understanding of what is covered in the agreement (e.g., limit on lines of business, commitment to pay policyholder claims, commitment to maintain RBC level, etc.) and the impact to the insurer.

Analysts should also consider the following:

- Expected source and form of liquidity should guarantees be called upon.
- If the parental guarantee or capital maintenance agreement specifically address the concerns identified and provide adequate support to the insurer.
    - If concerns exist, consider requesting additional information, as necessary, to understand the level of commitment.
- Whether the document contains detailed requirements or expectations for capital support.
- The financial stability of the parent holding company to determine if the parent is adequately capitalized to support maintenance of capital in the insurer above certain thresholds.

If a holding company analysis group profile summary (GPS) is available, analysts should review the GPS for insight into the parent company or ultimate controlling person (UCP) and its ability to meet the financial demands of the guarantee currently or prospectively. Review pertinent data on the holding company and its organizational structure as well as the operations and financial condition of the holding company or UCP. Determine if there are liquidity or other concerns identified within the GPS that warrant additional information from the company.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

TO: Greg Chew, Chair, Financial Analysis Solvency Tools (E) Working Group

FROM: Judy Weaver, Chair, Financial Analysis (E) Working Group

DATE: May 8, 2024

RE: Enhanced Guidance for Health Insurers

As you may be aware, the Financial Analysis (E) Working Group (FAWG) meets annually in Kansas City to discuss, among other things, potentially troubled insurers and insurance groups. During this meeting, FAWG also discusses issues and industry trends, including identifying any that are potentially adverse or might warrant communication and coordination with other NAIC groups. As a result of the issues and trends discussed, FAWG would like to refer the following item to the attention of your group.

1. **Pricing/Underwriting Risks of Health Insurers** – Health insurers are exposed to a wide range of pricing and underwriting risks that have the potential to rapidly impact their solvency position. This is particularly true for those insurers that participate in ACA Health Insurance Exchanges where guaranteed issuance is required, and pricing differences between participating insurers have the potential to result in significant variances in projected membership. As such, it is recommended that additional guidance on the pricing/underwriting risks faced by health insurers be considered for incorporation in the NAIC's *Financial Analysis Handbook*. In addition, a related issue is recommended for consideration as follows:

    a. **Failure to Plan for Variation in Membership Levels** – Many health insurers are exposed to significant swings in enrollment (increases or decreases), which can impact solvency if the company is not adequately capitalized (or have access to additional capital resources) and prepared to adjust operational support up or down to accommodate changes in membership. These strategic and operational risks are often interrelated with the pricing/underwriting risks outlined above.

If there are any questions regarding the proposed recommendations, please contact me or NAIC staff (Bruce Jenson at *bjenson@naic.org*) for clarification.

Pricing/Underwriting Risk Repository – Health Annual Additional Procedures

1. For health insurers who offer ACA plans, particularly smaller and/or newer health insurers in the ACA Exchange, consider the following additional procedures:
    a. Review and compare rates against their peers to identify any indications that they may be underpricing one or more of their products which could assist in determining the impact of the risk adjustment calculation.
    b. Gain an understanding and assess the insurer's expertise and resources for pricing ACA business and managing the impact of pricing and health care coding on the risk adjustment process.
    c. Inquire of the insurer and assess its prospective strategic plan for preparing for and managing the operational and capital support that would be necessary should the insurer experience potentially large shifts in enrollment.

Analyst Reference Guide – Pricing/Underwriting

Health insurers are exposed to a variety of pricing and underwriting risks that have the potential to impact their insolvency position. This is particularly true for those insurers that participate in the ACA Health Insurance Market Exchange where guaranteed issuance is required, and pricing differential of products between the participating insurers have the potential to result in significant variances in enrollments. In addition, health insurers are sometimes exposed to significant increases or decreases in enrollment which can greatly impact solvency if the insurer is not adequately capitalized or has access to additional capital resources to be prepared to adjust operational support either up or down to accommodate the swings in membership. These considerations increase the importance of closely reviewing pricing adequacy in ongoing solvency monitoring efforts.

The intent of the ACA risk adjustment program is to transfer funds from insurers with a relatively low-risk enrollee population to insurers with a relatively high-risk membership population. Operational and coding issues have the potential to impact the risk adjustment calculation and could result in an insurer owing a material risk adjustment payment even though it experienced higher than expected medical loss ratios. This can be most detrimental to some smaller or new insurers on the ACA Exchange where their projected marketing and growth strategy resulted in higher than projected claims experience. Insurers and regulators should be aware of the need to balance gaining membership growth, e.g., by creating more competitive pricing, with the insurer's sustainability and future solvency, especially for smaller or newer health insurers. It is possible at times, that increased membership at lower prices could result in better overall risk than the market average which results in the insurer paying into the risk assessment program, which in turn puts upward pressure on future premium as the insurer should account for future risk assessment payments.

It is important for regulators to evaluate and assess the insurer's operational and coding expertise in this area, particularly for those insurers that may be thinly capitalized or growing quickly, where the risk adjustment calculation could potentially negatively impact insurer solvency. Further the risk assessment process is complicated and requires expertise and significant resources that may result in unpredictable results and initially disadvantage a smaller or new health insurance carrier.