

Draft date: 5/20/24

Virtual Meeting

RISK-FOCUSED SURVEILLANCE (E) WORKING GROUP

Thursday, May 30, 2024

3:00 p.m. – 4:00 p.m. ET / 2:00 – 3:00 p.m. CT / 1:00 – 2:00 p.m. MT / 12:00 – 1:00 p.m. PT

ROLL CALL

Amy Malm, Chair	Wisconsin	Pat Gosselin	New Hampshire
Lindsay Crawford, Vice Chair	Nebraska	John Sirovetz/Paul Lupo	New Jersey
Sheila Travis/Blase Abreo	Alabama	Mark McLeod	New York
Laura Clements/Michelle Lo	California	Jackie Obusek/Monique Smith	North Carolina
Jack Broccoli/William Arfanis	Connecticut	Dwight Radel/Tracy Snow	Ohio
Carolyn Morgan/Jane Nelson	Florida	Eli Snowbarger	Oklahoma
Cindy Andersen	Illinois	Ryan Keeling	Oregon
Roy Eft	Indiana	Diana Sherman	Pennsylvania
Daniel Mathis	Iowa	John Tudino/Ted Hurley	Rhode Island
Stewart Guerin	Louisiana	Johanna Nickelson	South Dakota
Vanessa Sullivan	Maine	Amy Garcia	Texas
Dmitriy Valekha	Maryland	Jake Garn	Utah
Judy Weaver	Michigan	Dan Petterson	Vermont
Debbie Doggett/ Shannon Schmoeger	Missouri	Jennifer Blizzard/Greg Chew Tarik Subbagh/Steve Drutz	Virginia Washington

NAIC Support Staff: Bruce Jenson/Jane Koenigsman

AGENDA

1. Discuss and Consider Finalizing the Affiliated Investment Management Agreement Review Guidance—*Amy Malm (WI)*
 - a. AHIP Comment Letter Attachment A
 - b. Updated Draft of Proposed Guidance Attachment B
2. Discuss Referral from FAWG on Run-Off Insurers—*Amy Malm (WI)* Attachment C
3. Discuss Any Other Matters—*Amy Malm (WI)*
4. Adjournment



April 30, 2024

Amy Malm, Chair
Risk-Focused Surveillance (E) Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

By Email to Bruce Jenson, BJenson@naic.org

**Re: AHIP Comments – Risk-Focused Surveillance (E) Working Group Exposure -
Comments Due April 30 re: Investment Management Agreements**

Dear Ms. Malm:

On behalf of the members of Americas Health Insurers Plans (AHIP), we appreciate the opportunity to provide comments to the NAIC’s Risk-Focused Surveillance (E) Working Group (RFSWG) on the Exposure Draft of proposed revisions to the NAIC’s Financial Analysis Handbook (FAH) with respect to Investment Management Agreements (IMAs).

While the exposure also encompasses proposed revisions to the text of the NAIC Financial Examiners Handbook, our concern is with respect to a proposed revision that would impact only the FAH. The second page of the exposure includes the following passage (the RFSWG’s suggested revisions are shown in underlined text):

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 advisers, broker/dealer or individuals acting on behalf of the insurer with access to their investment accounts?

If “yes”, consider the following procedures:

1

- 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 have been filed for all key advisors and request 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.

The NAIC’s Model Insurance Holding Company System Regulatory Act (440) section 6(A) generally provides that “the commissioner shall have the power to examine any insurer registered under Section 4 and its affiliates to ascertain the financial condition of the insurer, including the enterprise risk to the insurer by the ultimate controlling party, or by any entity or combination of entities within the insurance holding company system, or by the insurance holding company system on a consolidated basis.” Section 6(B)(1) provides authority for the Commissioner to access books and records: “The commissioner may order any insurer registered under Section 4 to produce such records, books, or other information papers in the possession of the insurer or its affiliates as are reasonably necessary to determine compliance with this Chapter.”

AHIP recognizes the foregoing provisions of Model 440, that they are implemented in the various states, and that they give the authority of state insurance regulator to access IMAs that have been entered into by an insurer, whether with affiliated or non-affiliated parties.

While the states have had that authority now for some time, our members indicate that, as a practical matter, most states do not currently require that IMAs with non-affiliated parties be filed as a matter of course in the absence of some specific rationale that is associated with the specific parties to the agreement or other concerns that might exist about the IMA between those parties.

As worded, the proposed revisions to the FAH that are cited above would cause all states to now “request copies of agreements [IMAs] that have not been filed with the department for review”. The text suggests that *all* such agreements be filed. Further, that would apply to IMAs with non-affiliates as well as to affiliates and impose a new requirement on state financial analysts that, in many cases, the state itself has not seen fit to impose to date through its own legislative or rule-making processes. Finally, we note that nothing in the exposure itself or, to our knowledge, in the publicly available RFSWG meeting materials leading up to the exposure, has provided a rationale as to why such a blanket requirement is necessary for non-affiliated IMAs. Absent some evidence to the contrary, IMAs with non-affiliates are presumably negotiated on an arms-length basis and much less prone to the types of concerns that regulators may have with similar agreements an insurer may have with an affiliated party.

In AHIP’s prior meetings with members of the RFSWG regarding changes to the FAH and the Examiners Handbook regarding affiliated agreements more generally, RFSWG members

commented that state insurance department analysts are already challenged with the amount of work before them as it is; this would greatly expand their work load by requiring them to review many more agreements and without any rationale to suggest any problems that they should be looking for. The RFSWG's suggested revisions would impose a substantial compliance burden on state insurance department analysts and insurers alike in the absence of a stated concern that would somehow be alleviated or the nature and extent of that concern. Further, there has been no representation by the RFSWG as to a cost/benefit analysis for the proposed change.

AHIP suggests that the text of the second indented bullet in the passage cited above from the FAH be changed as follows (AHIP's suggested revisions are shown in marked text):

- “Verify that Investment Management Agreements that the state requires to be filed have been filed for all key advisors and, to the extent that required filings have not yet been submitted, request copies of those required agreements that have not been filed with the department for review.”

These suggested revisions would not preclude regulators from accessing IMAs with non-affiliates; examiners could continue to consider requesting selected non-affiliated IMA agreements in the course of an examination as has been the customary practice to date.

Thank you for the opportunity to provide these suggestions and comments, and we look forward to further discussing these matters with you.

Sincerely,

Bob Ridgeway
Bridgeway@ahip.org 501-333-2621

AHIP is the national association whose members provide health care coverage, services, and solutions to hundreds of millions of Americans every day. We are committed to market-based solutions and public-private partnerships that make health care better and coverage more affordable and accessible for everyone by promoting, among other things, effective and efficient financial analysis and examination processes by state insurance regulators.

Note: This document includes excerpts from both the NAIC’s *Financial Analysis Handbook* and the *Financial Condition Examiners 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.

-----Text deleted to conserve space-----

Additional Analysis and Follow-up Procedures

-----Text deleted to conserve space-----

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 for all key advisors 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

-----Text deleted to conserve space-----

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 analysts 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.

-----Detail Eliminated to Conserve Space-----

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**

-----Detail Eliminated to Conserve Space-----

Form D – Prior Notice of a Transaction

PROCEDURES #1-186 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.

-----Detail Eliminated to Conserve Space-----

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.

Examination 1 – Section 1-III F. Outsourcing of Critical Functions

III. GENERAL EXAMINATION CONSIDERATIONS

This section covers procedures and considerations that are important when conducting financial condition examinations. The discussion here is divided as follows:

- A. General Information Technology Review
- B. Materiality
- C. Examination Sampling
- D. Business Continuity
- E. Using the Work of a Specialist
- F. Outsourcing of Critical Functions
- G. Use of Independent Contractors on Multi-State Examinations
- H. Considerations for Insurers in Run-Off
- I. Considerations for Potentially Troubled Insurance Companies
- J. Comments and Grievance Procedures Regarding Compliance with Examination Standards

-----Text deleted to conserve space-----

F. Outsourcing of Critical Functions

The examiner is faced with additional challenges when the insurer under examination outsources critical business functions to third parties. It is the responsibility of management to determine whether processes which have been outsourced are being effectively and efficiently performed and controlled. This oversight may be performed through a number of methods, including performing site visits to the third-party or through a review of Statement of Standards for Attestation Engagements (SSAE) 18 work that has been performed. In some cases, performance of site visits may even be mandated by state law. However, regardless of where the business process occurs or who performs it, the examination must conclude whether financial solvency risks to the insurer have been effectively mitigated. Therefore, if the insurer has failed to determine whether a significant outsourced business process is functioning appropriately, the examiner may have to perform testing of the outsourced functions to ensure that all material risks relating to the business process have been appropriately mitigated.

When conducting an examination of insurers that are part of a holding company group, including internationally active insurance groups (IAIGs), the exam team should evaluate whether appropriate due diligence has been performed prior to entering new material outsourcing agreements. The exam team should also take steps to determine the extent to which management at the applicable level (e.g., head of the IAIG, ultimate parent company level, insurance holding company level, legal entity level, etc.) is able to provide ongoing risk assessment and oversight of outsourced functions and any contingency plans for emergencies and service disruptions.

The guidance below provides examiners additional information about the outsourcing of critical functions a typical insurance company may use. The guidance does not create additional requirements for insurers to comply with beyond what is included in state law, but may assist in outlining existing requirements that may be included in state law and should be used by examiners to assess the appropriateness of the company’s outsourced functions. Within the guidance, references to relevant NAIC model laws have been included to provide examiners with guidance as to whether compliance in certain areas is required by law. To assist in determining whether an individual state has adopted the provisions contained within the referenced NAIC models, examiners may want to review the state pages provided within the NAIC’s *Model*

Laws, Regulations and Guidelines publication to understand related legislative or regulatory activity undertaken in their state.

Types of Service Providers

Insurance companies have been known to outsource a wide range of business activities including sales & marketing, underwriting & policy service, premium billing & collections, claims handling, investment management, reinsurance and information technology functions. There are a number of different types of entities that accept outsourced business from insurers including the following:

- **Managing General Agent** – Person who acts as an agent for such insurer whether known as a managing general agent, manager or other similar term, who, with or without the authority, either separately or together with affiliates, produces, directly or indirectly, and underwrites an amount of gross direct written premium equal to or more than five percent (5%) of the policyholder surplus as reported in the last annual statement of the insurer in any one quarter or year together with the following activity related to the business produced adjusts or pays claims in excess of \$10,000 per claim or negotiates reinsurance on behalf of the insurer.
- **Producer** – An insurance broker or brokers or any other person, firm, association or corporation, when, for any compensation, commission or other thing of value, the person, firm, association or corporation acts or aids in any manner in soliciting, negotiating or procuring the making of an insurance contract on behalf of an insured other than the person, firm, association or corporation.
- **Controlling Producer** – A producer who, directly or indirectly, controls an insurer.
- **Custodian** – A national bank, state bank, trust company or broker/dealer which participates in a clearing corporation.
- **Investment Adviser** – A person or firm that, for compensation, is engaged in the act of providing advice, making recommendations, issuing reports or furnishing analyses on securities. In addition to providing investment advice, some investment advisers also manage investment portfolios or segments of portfolios. Other common names for investment advisers include asset managers, investment managers and portfolio managers.
- **Affiliated Service Provider** – An affiliated person or firm to which the insurer outsources ongoing business services, including cost sharing services and management services.
- **Other Third-Party Administrators** – Other third-party entities that perform business functions of the insurer.

Additional information on each of the above types of entities has been provided below to assist examiners in reviewing business activities outsourced.

-----Text deleted to conserve space-----

Investment Advisers

As investments and investment strategies grow in complexity, insurers may consider the use of 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 (SEC) Commission and by the states in which they operate generally based on the size of their business. In certain situations, insurers may use a broker dealer in the capacity of an investment adviser. 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, which provides extensive information about the nature of the organization's operations. To locate these forms, the examiner can go to www.adviserinfo.sec.gov and perform a search based on the company name.

Key information provided on a Form ADV includes:

- f. Locations in which the adviser/broker is registered
- g. Information about the advisory business including size of operations and types of customers (Item 5)
- h. Information about whether the company provides custodial services (Item 9)
- i. Information about disciplinary action and/or criminal records (Item 11)

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 very valuable to examiners in assessing the suitability of investment advisers providing advisory services to insurers.

Where not prohibited by domiciliary state law and if permitted by the investment adviser agreement, there may be situations in which the investment adviser also acts as a custodian. In these instances, investment advisers are required to obtain an annual examination by an independent public accountant to verify compliance with custodial responsibilities as provided in the federal Investment Advisers Act of 1940 and/or the federal Investment Company Act of 1940. The accountant's report is also available on the Form ADV. It is generally 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 discussion under the topic of "Custodian" above for more information.

In performing risk-focused examinations, examiners should identify all advisers utilized by the insurer and take steps to address any significant risks associated with their use. These steps may include determining whether investment advisers are suitable for their role (including registered and in good standing with the SEC and/or state securities regulators), performing procedures to ensure investment advisory agreements contain appropriate provisions, and performing procedures to ensure that the adviser is acting in accordance with the agreement. Additionally, the examiner may consider performing procedures to determine if management/board oversight of the investment adviser is sufficient for the relationships in place.

In evaluating the provisions of the investment advisory/management agreements, examiners should consider whether there are appropriate provisions to adequately address selection of investments, authority for transactions, conflicts of interest, calculation of fees, etc. Additional considerations for use in reviewing the investment advisory/management agreements are provided as follows:

- a. Selection of Investments

It should be clear from the advisory agreement, how the investment adviser will select investments. This should include specific reference to the insurer's investment strategy and detailed investment guidelines attached as part of the agreement.

- b. Authority for Transactions

Advisory agreements should address the level of the 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, t~~The advisory agreement should specifically indicate the manner in which such conflicts of interest will be considered. This is an important protection against an investment adviser’s biases as a result of business arrangement (e.g., referral relationships, affiliate product offerings, etc.) that may interfere with the proper execution of the investment strategy. This is an important consideration when the investment adviser has other clients. 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. The reporting of potential conflicts of interest and how they are addressed should also be included in the insurer’s management and controls framework.

d. Fiduciary Responsibility

It is advisable that the investment advisor is registered with the SEC. However, whether or not that is the case, the agreement should acknowledge that the investment advisor is subject to guidance and requirements under the Investment Advisors Act of 1940. Language provided in the investment management agreement should acknowledge the investment adviser’s role as a fiduciary in advising the insurer. 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. If not already performed by the financial analyst, the exam team 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 exam team should consider verifying that the advisor continues to meet the exemption criteria.

e. Calculation of Fees

Management fees should reflect the current market conditions and should reflect the kind of assets and type of asset management performed. 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. 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. Special attention should be paid if there are any performance or incentive fees over and above a base management fee. 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.

f. Sub-advisors

Can the investment advisor engage sub-advisors? Is consent of the insurer required, or can the insurer revoke the engagement? Who is responsible for the fees of the sub-advisor and are they included in the overall fee structure (i.e., not overlapping)?

g. Reporting

Are there adequate provisions for reporting to the insurer on regular basis. There should be provision for any regulatory needs and any other needs of the insurer that are within reason.

h. Termination

Are there appropriate termination provisions, both with and without cause? Is there language providing for the transition to another investment adviser.

f.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.

There may be other terms that examiners consider to be significant and can therefore tailor their review based on judgment and the specifics of the insurer under exam. For related guidance regarding affiliated investment manager agreements, please see Section V. C. Domestic and/or Non-Lead State Analysis – Form D Procedures of the NAIC's *Financial Analysis Handbook*.

Examiners may consider leveraging risk, control and test procedure language provided in the Investment repository when determining an appropriate examination response. The examiner may also consider concepts discussed in the "Other Third-party Administrators (TPAs)" and "Custodial or Safekeeping Agreements" to ensure that risks are adequately addressed as part of examination fieldwork.

Examination 2 – Investments Repository Excerpts

Identified Risk	Branded Risk	Exam Asrt.	Critical Risk	Possible Controls	Possible Test of Controls	Possible Detail Tests
Other Than Financial Reporting Risks						
<p>The board of directors (or committee thereof) and management do not effectively monitor or supervise contracted third parties (including affiliates) in the implementation of the investment policy/strategy.</p> <p>*See Section 1 Part III of the Handbook for additional guidance relevant to reviewing third-party investment advisers and associated contractual arrangements.</p>	CR MK	Other	AIPS	<p>Prior to entering into a contract with a third party, management reviews the third party’s credentials to ensure that they are qualified to perform the service and verifies that no conflict of interest exists.</p> <p>Management ensures that third-party contracts include appropriate provisions and recognize fiduciary responsibility to the insurer. Contracts are reviewed for appropriate provisions related to:</p> <ul style="list-style-type: none"> • Investment guidelines/selection. • Authority for transactions. • Reporting of transactions in sufficient detail and frequency. • Conflicts of interest. • Appropriateness of fees. 	<p>Review procedures that ensure management reviews the credentials, including confirming registration as investment advisor/manager, of the third party and that no conflict of interest exists.</p> <p>Verify the insurer control to ensure appropriate contract provisions. Specifically consider any situations and transactions where the potential of conflict of interest exists. This includes transactions with other accounts managed by the third-party manager, through brokers affiliated with the third-party manager and investments in funds managed separately by the third-party manager.</p>	<p>Assess the suitability of investment advisers through a review of information provided to the U.S. Securities and Exchange Commission (SEC) in Form ADV (if available) or other available information. Determine if there are any disciplinary actions or background information that might call into question the advisers’ suitability for providing services rendered.</p> <p>Review significant investment advisory/management agreements for appropriate provisions.</p> <p>Review recent performance and benchmark reports in comparison with the company’s plan.</p> <p>Test the insurer’s investments for compliance</p>

Identified Risk	Branded Risk	Exam Asrt.	Critical Risk	Possible Controls	Possible Test of Controls	Possible Detail Tests
				<ul style="list-style-type: none"> • Review of performance. • Termination. <p>The insurer monitors investments purchased, those sold, the performance of the investment portfolio against prior year or budgeted results, and what the insurer holds. It also monitors compliance with the investment strategy that has been established by the board of directors (or committee thereof). This monitoring can be performed by senior management, an investment advisory board or internal auditors and is reported to the board of directors (or committee thereof).</p> <p><u>Processes are in place to ensure proper disclosure, regulatory approval (if applicable) and reporting of all authorized investment advisors and sub-advisors.</u></p>	<p>Obtain a copy of the report that is used by the insurer to report investment policy compliance to the board of directors (or committee thereof), and verify the board’s review of the investment activity.</p> <p>Verify that a discussion of investments took place at the board of directors (or committee thereof) meeting by reviewing a sample of meeting minutes.</p> <p><u>Review and test company processes in place (including supervisory review) to ensure proper disclosure, reporting, and regulatory approval (if applicable) of all authorized investment advisors and sub-advisors</u></p>	<p>with its investment policy guidelines.</p> <p>Assess significant changes in portfolio profile year over year and over the course of recent years to determine suitability of changes for the company.</p> <p><u>Verify that all investment management agreements with affiliated entities have been filed with the department for approval.</u></p> <p><u>Verify that information related to investment advisors is properly disclosed in the general interrogatories.</u></p>

Identified Risk	Branded Risk	Exam Asrt.	Critical Risk	Possible Controls	Possible Test of Controls	Possible Detail Tests
						<p><u>Verify that information on investments is properly reported as to the affiliated/related-party status in the annual statement investment schedules.</u></p>
<p>Structured security <u>or other complex</u> investments originated and managed by an affiliate or related party may present an increased exposure to solvency risks.</p>	<p>CR ST MK</p>	<p>Other</p>	<p>AIPS VIIA</p>	<p>The insurer verifies that its affiliate/related party asset manager has adequate experience and knowledge in originating and managing the types of investments held by the insurer.</p> <p>The insurer verifies that its affiliate/related party asset manager follows appropriate underwriting practices in originating investments.</p> <p>The insurer has established guidelines for investments originated and managed by affiliates/related parties to ensure that:</p> <ul style="list-style-type: none"> The fee structure is transparent, <u>and</u> equitable, <u>and</u> 	<p>Review documentation demonstrating that management reviews the credentials of the affiliate/related party, including confirming registration as investment advisor/manager and that no conflict of interest exists.</p> <p>Review internal audit (IA) work, board minutes, and/or other documentation demonstrating effective oversight of the affiliated asset origination process.</p> <p>Review documentation demonstrating that the insurer has reviewed the investments originated and managed by an affiliate or related party for compliance with regulatory investment limitations and reporting requirements.</p>	<p>Review significant investment advisory/management agreements for appropriate provisions.</p> <p>Test the insurer’s investments for compliance with its investment policy guidelines and regulatory requirements.</p> <p>If necessary, use an investment specialist to analyze the insurer’s structured securities portfolio.</p> <p>Review Jumpstart reports to identify potential designation exceptions for structured securities and address exceptions, as appropriate. If deemed necessary, review individual securities for</p>

Identified Risk	Branded Risk	Exam Asrt.	Critical Risk	Possible Controls	Possible Test of Controls	Possible Detail Tests
				<p><u>avoids overlapping and excessive fees.</u></p> <ul style="list-style-type: none"> • Concentration of such investments is in accordance with affiliated investment limitations. • Investments offered to the public are in compliance with applicable requirements. <p>The insurer has a process in place to have its structured securities effectively rated by a qualified third party and assesses the appropriateness of ratings and designations.</p> <p>The insurer has a process in place to ensure that investments managed and originated by affiliates/related parties are properly identified and reported in accordance with statutory accounting guidelines.</p> <ul style="list-style-type: none"> • This includes proper classification of 	<p>Obtain documentation demonstrating management’s review and approval of third-party ratings for structured securities.</p> <p>Review the insurer’s process for identifying reporting investments managed and originated by affiliates/related parties, and determine whether it is operating effectively.</p> <p>Obtain documentation demonstrating how management determines the</p>	<p>compliance with NAIC designation reporting requirements.</p> <p>If deemed appropriate, select a sample of material investments and review the underlying details to determine if the investments are properly classified in the respective investment schedules in the annual statement.</p>

Identified Risk	Branded Risk	Exam Asrt.	Critical Risk	Possible Controls	Possible Test of Controls	Possible Detail Tests
				<p>holdings reported in the “Investments Involving Related Parties” column of each investment schedule in the annual statement.</p>	<p>classification of investments in the annual statement.</p>	

MEMORANDUM

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

FROM: Judy Weaver, Chair, Financial Analysis (E) Working Group

DATE: May 8, 2024

RE: Enhanced Guidance for Run-off Companies

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. **Solvency Monitoring of Run-off Insurers** – Insurers that are no longer actively writing new business but continuing to service policies and run-off long term claim liabilities often require customized solvency monitoring procedures and considerations. While both the *Financial Analysis Handbook* and the *Financial Condition Examiners Handbook* already provide some guidance for customizing solvency monitoring procedures in this situation, FAWG discussed several additional sound practice considerations in this area at its recent meeting. As these sound practices could benefit from careful coordination across analysis and exam functions, they are being referred to the Risk-Focused Surveillance (E) Working Group for further study and development for use in both financial analysis and examination processes. Some of the sound practices identified include the following:
 - a. **Run-off Plan** – Request a run-off plan from the insurer at the beginning of the run-off process to assist regulators in monitoring the progress and success of run-off operations. Ensure that the run-off plan covers size of operations during the run-off, employee retention plans, and key performance indicators and metrics for the run-off (including cashflow projections and ALM plans).
 - b. **Logistics and Records** – Gain an understanding of the insurer’s record-keeping processes, with special attention paid to claims records and data sources, including the ability to transfer claims data as needed in a timely manner. In addition, develop a detailed understanding of the insurer’s use of service providers and third-party administrators, including plans for continuity of services as operations shrink over time.
 - c. **Communications** – Identify key stakeholders in the run-off process, including other state regulators and receivership/guaranty fund contacts. Ensure that sufficient confidentiality measures are in place to govern and protect communications with other stakeholders. Develop a plan to communicate appropriate information in a timely and effective manner throughout the course of the run-off.
 - d. **Legal Risk (LG)** – Legal risks have the potential to be more significant to run-off insurers given their limited ability to adjust pricing or take other actions to address legislative changes, changes in case law, or litigation activity with the ability to significantly impact loss reserves. Therefore, it

EXECUTIVE OFFICE • 444 North Capitol Street NW, Suite 700 • Washington, DC 20001-1509

p | 202 471 3990 f | 816 460 7493

CENTRAL OFFICE • 1100 Walnut Street, Suite 1500 • Kansas City, MO 64106-2197

p | 816 842 3600 f | 816 783 8175

CAPITAL MARKETS & INVESTMENT ANALYSIS OFFICE • One New York Plaza, Suite 4210 • New York, NY 10004

p | 212 398 9000 f | 212 382 4207

www.naic.org

may be appropriate to require regular legal risk update reports, involve those with legal knowledge and expertise in monitoring the company, or take other actions to monitor the impact of legal risks more closely on run-off companies.

- e. **Operational Risk (OP)** – There are multiple unique operational risks with the potential to impact run-off insurers, including the following:
 - i. **Employee Retention** – Given the fact that employee retention may be more difficult for a run-off insurer to manage, it is important to ensure that the company maintains qualified officers with sufficient knowledge and experience throughout the course of the run-off. Therefore, it may be appropriate to closely monitor employee turnover and request additional reporting on any changes in senior officers throughout the run-off period.
 - ii. **IT Systems** – It is important to assess whether IT systems are kept up to date and secure throughout the runoff, while also ensuring cost effectiveness. Therefore, regulators should continue to emphasize the IT system review as required for full-scope financial exams, and/or consider targeted exams in between full-scope financial exams when appropriate.
- f. **Liquidity Risk (LQ)** – The ability to manage liquidity risk can be of heightened importance to run-off insurers given limited resources and flexibility. Therefore, regulators should closely monitor annual investment income in relation to expenses of operations, using pro forma projections, and reconciling differences. If operating expenses for a runoff insurer exceed investment income, which could be their only source of income, then resulting losses could quickly erode policyholders' surplus.
- g. **Reserving Risk (RV)** – Given the materiality of loss reserves to many run-off companies, a slight variance in reserves can have a significant impact on the insurer's ability to continue as a going concern. As a result, there is increased importance placed on highly accurate reserve estimations as well as close monitoring of loss reserves. Therefore, it may be appropriate to conduct independent reserve estimations and reviews more frequently than once every five years through the examination cycle.
- h. **Reinsurance Risks (ST & CR)** – Run-off insurers can benefit from carefully monitoring and applying reinsurance coverage in place to ensure that covered losses are identified and collected. In addition, reinsurance recoverable amounts and the credit risk associated with reinsurance can often be material to the solvency position of run-off insurers. Therefore, regulators should closely monitor insurer operations in this area.

Given the Risk-Focused Surveillance (E) Working Group's role in ensuring consistency between analysis and examination processes, the sound practices are being referred for its review before consideration of adoption into NAIC handbooks. If there are any questions regarding the proposed recommendations, please contact me or NAIC staff (Bruce Jenson at bjenson@naic.org) for clarification.