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Risk-Based Capital Investment Risk and Evaluation (E) Working Group
Portland, Oregon
August 11, 2022

The Risk-Based Capital Investment Risk and Evaluation (E) Working Group of the Capital Adequacy (E) Task Force met Aug. 11, 2022. The following Working Group members participated: Philip Barlow, Chair (DC); Thomas Reedy (CA); Wanchin Chou (CT); Virginia Christy (FL); Carrie Mears and Kevin Clark (IA); Vincent Tsang and Bruce Sartain (IL); Fred Andersen (MN); Nolan Beal (NE); Bob Kasinow and Bill Carmello (NY); Dale Bruggeman and Tom Botsko (OH); Rachel Hemphill (TX); Steve Drutz (WA); and Adrian Jaramillo (WI).

1. Adopted its 2022 Spring National Meeting Minutes

Mr. Bruggeman made a motion, seconded by Mr. Chou to adopt the 2022 Spring National Meeting Minutes (*see NAIC Proceedings – Spring 2022, Capital Adequacy (E) Task Force, Attachment Seven*). The motion passed unanimously.

2. Adopted its Working Agenda

Mr. Barlow noted the number of items included in the working agenda and said the Working Group is going to prioritize those items directed to the Working Group by the Financial Condition (E) Committee, particularly the work on collateralized loan obligations (CLOs). Ms. Mears made a motion, seconded by Mr. Bruggeman to adopt the working agenda (Attachment Nine). The motion passed unanimously.

3. Received Updates from the Valuation of Securities (E) Task Force and the Statutory Accounting Principles (E) Working Group

Mr. Barlow said it is important to have the chairs of these two groups as members of this Working Group because it is clear to him that there needs to be collaboration from the beginning in determining appropriate RBC charges. He said it is also important to have the chairs of the Capital Adequacy (E) Task Force and the other RBC working groups as members because, while most of the interest may be for life insurers, consistency in the RBC formulas is a goal where appropriate so it is good to have all parties involved as early in the process as possible.

Ms. Mears said the Valuation of Securities (E) Task Force is working to potentially give direction to NAIC staff to begin modeling CLOs. She said this work will be to remove CLOs from the filing exempt (FE) process and instead utilize a modeling process with the intent being to effectively normalize treatment across CLOs by making them subject to the same modeling process and results. At this point, she said the details of this process have not been fully defined but the Task Force exposed their intent to pursue this for comment with some of those comments suggesting aspects to be considered in more detail. She said the Task Force will be discussing these in what is planned to be a very transparent process involving all stakeholders. She said a referral to this working group to look at the risk-based capital (RBC) factors with some recommendations to be considered will likely be part of this process. She emphasized the point that, with or without any changes to the RBC framework, the modeling, and the resulting normalization of the treatment of CLOs will be incredibly valuable.

Mr. Bruggeman provided an update from the Statutory Accounting Principles (E) Working Group. He highlighted the work of regulators and key industry representatives on the principles-based bond project to better define what is permitted to be reported as a bond on Schedule D, Part 1, to improve accounting and reporting, and ensure regulators have transparency to the investment risks held by insurers. As a result of this collaborative effort, he said the Working Group has been successful in developing and recently exposing several documents for comment. This included an updated bond definition, issue paper and proposed revisions to SSAP 26R—Bonds and SSAP No. 43R—Asset Backed Securities to incorporate the bond definition concepts into authoritative statutory accounting guidance. Mr. Bruggeman said these revisions, once adopted and in effect, will improve the designation of investments as bonds, requiring that the investments qualify as bonds in substance, not just legal form. He said the revisions should also significantly improve consistency with the allocation of bond investments between SSAP No. 26R and SSAP No. 43R, and the application of accounting provisions specific to each SSAP, such as the assessment of cash flows or impairment, for similar types of securities.

While these exposures are significant, Mr. Bruggeman said the exposures that occurred during an interim call on July 18 may be of more interest to this group. Those exposures reflect significant reporting revisions to Schedule D, Part 1 to capture valuable information on actual investments held by insurers. This includes a proposed expansion of Schedule D, Part 1 from one to two separate schedules. Schedule D-1-1 will include issuer obligations and schedule D-1-2 will include asset backed securities (ABS). The sum of the two schedules will still roll up to the Bonds line on the Assets page. With the separation of the schedules, different data columns can be designed based on the broad investment classification. A review of the reporting instructions has been completed and several revisions are proposed to streamline reporting, eliminate elements not applicable to certain securities, and propose new columns to capture desired information. Mr. Bruggeman said the revisions should result in providing improved information to regulators as well as eliminating inconsistency or uncertainty for industry in compliance. Lastly, he said a key change for more granular reporting, rather than classifying all bonds into one of four generic reporting groups, new reporting groups have been proposed to separate investments based on underlying characteristics. An example of this is instead of classifying all ABS as either residential mortgage-backed, commercial mortgage backed or other ABS, reporting lines are proposed to separate ABS based on whether they are financial asset-backed-self-liquidating, financial asset-backed-non-self-liquidating, non-financial asset-backed, etc. Although these categories provide valuable information, specific reporting lines within these categories have been proposed to be even more granular. Mr. Bruggeman noted the concern with being able to identify CLOs accurately in the financial statements and the use of the collateral codes in determining underlying investments. He said the proposed reporting revisions would separately capture CLOs as a type of financial asset backed security. Whether these granular reporting lines are utilized immediately for RBC, by having this structure in place, he said future assessments, along with ease of understanding the magnitude of certain types of investments, will be easier. He noted questions pertaining to the effective date and transition and said the earliest the guidance could be effective, with both accounting and reporting revisions in place, would be January 1, 2024, but it is likely the revisions will be effective January 1, 2025. With respect to transition, Mr. Bruggeman said there is no grandfathering planned for investments to continue to be reported as bonds that do not comply in order to ensure consistency with reporting across entities. Although grandfathering guidance is not expected, he said some practical transition assessments will be considered and reasonable accommodations are anticipated to prevent undue hardship for reporting entities in complying with the guidance.

4. Discussed the Working Group's Next Steps

As the Working Group addresses the items on its working agenda, Mr. Barlow said he has goals he would like for the Working Group to achieve in order to accomplish that work. He said the first of these is to have information, to the extent possible, easily identifiable from the annual statement through to the RBC charge with a minimum of reliance on company records so that the RBC charge for a particular asset is clear and that two companies having the same asset will end up with the same RBC charge. He said a second goal is to make sure it is clearly understood what risks are being analyzed in the process of assigning ratings to assets as well as those risks that may not be part of the analysis so that it is evident whether some adjustment is needed for the purpose of developing an RBC charge. He said a third goal is to have a structure for RBC that facilitates new types of assets as they appear with the ability to identify them as new items that have not been evaluated yet and assign them an interim or introductory RBC treatment until any needed analysis can be done as opposed to trying to fit them into existing categories. He said he would like the Working Group to keep these goals in mind as it works through the individual projects before it.

Mr. Barlow said the Working Group has received direction from the Financial Condition (E) Committee to focus its attention on two items which the Working Group will look at simultaneously. He said the first is to develop an approach for determining RBC charges for CLOs and the second is to look at a potential interim approach to address concern about potential arbitrage in the structuring of assets through CLOs and similar kinds of assets. Whether it involves assets or other items in RBC, Mr. Barlow said he believes it is important that the opportunity to reconfigure risks and end up with a different RBC charge is eliminated. To that end, he said the Working Group will consider whether there is something that should be done in the shorter term to address that aspect. If there is an interim step that the Working Group pursues, he said it should be intended to stay in place only until a new more fully developed methodology is determined so it may not have the same degree of rigor but it should have sufficient analysis done so that there are no unintended consequences. He said there may be ways other than specific RBC charges to address an interim approach and said the Working Group is welcome to input from all parties. For clarification, Mr. Bruggeman asked if the work being considered for CLOs includes all of the tranches, those that would be on the bond schedule and residual tranches. Mr. Barlow said he meant all of the tranches. While the Valuation of Securities (E) Task Force is looking at CLOs currently, Ms. Mears said she believes it is important for this working group to be cognizant of the broader universe of structured assets.

Mr. Barlow said he has asked the American Academy of Actuaries (Academy) if this is a project they would be willing to assist with. Steve Smith (Academy) said the Academy is willing to help with the CLO project. He said the Academy's view is that it is important to have actuarial review of any model that has downstream impact on RBC and that includes a consideration of the broader statutory framework and broader solvency framework within RBC. Mr. Barlow agreed and said the Academy in general, and actuaries in particular, have contributed a lot of expertise to many if not all aspects of RBC and he would like to make sure that continues. He said he believes it is important to try to coordinate with the work that the Valuation of Securities (E) Task Force is doing on modeling CLOs and a good first step would be, as that work develops, to have it shared with the Academy. If some adjustment is needed for the purpose of RBC, he said as long as all parties are involved in the process from the beginning it will put the Working Group in a good position to consider if that can be done and have it work for the purposes of those involved.

5. Received a Referral from the Macroprudential (E) Working Group

Mr. Barlow said a referral from the Macroprudential (E) Working Group has been received and will be added to the working agenda.

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

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