ROLL CALL

David Altmaier, Chair  Florida  Chlora Lindley-Myers  Missouri
Todd E. Kiser, Vice Chair  Utah  Barbara D. Richardson  Nevada
Jim L. Ridling  Alabama  Marlene Caride  New Jersey
Lori K. Wing-Heier  Alaska  John G. Franchini  New Mexico
Ricardo Lara  California  Mike Causey  North Carolina
Andrew N. Mais  Connecticut  Jillian Froment  Ohio
Trinidad Navarro  Delaware  Glen Mulready  Oklahoma
Stephen C. Taylor  District of Columbia  Elizabeth Kelleher Dwyer  Rhode Island
Robert H. Muriel  Illinois  Kent Sullivan  Texas
Doug Ommen  Iowa  Mike Kreidler  Washington
Vicki Schmidt  Kansas  Mark Afable  Wisconsin
Steve Kelley  Minnesota

NAIC Support Staff: Jane Barr/Lou Felice

AGENDA

1. Consider Adoption of its Oct. 8 Minutes—Commissioner David Altmaier (FL)  Attachment One

2. Consider Adoption of its Working Group Reports and Minutes  
   —Commissioner David Altmaier (FL)  
   a. Health Risk-Based Capital (E) Working Group  Attachment Two
   b. Life Risk-Based Capital (E) Working Group  Attachment Three
   c. Property and Casualty Risk-Based Capital (E) Working Group  Attachment Four

3. Consider Adoption of its Working Agenda—Commissioner David Altmaier (FL)  Attachment Five
   a. Working Agenda
   b. Hear Update Regarding the Affiliated Investment Ad Hoc Group

4. Receive Long-Term Care/Guaranty Fund Memorandum—Patrick McNaughton (WA)  Attachment Six

5. Consider Adoption of Property and Casualty Risk-Based Capital (E) Working Group Proposals  
   —Tom Botsko (OH)  
   c. Proposal 2019-11-P (Instruction Clarification and 2019 Reporting Guidance)  Attachment Seven
   d. Proposal 2019-12-P (Remove Adjustment for Reinsurance Penalty)  Attachment Eight

6. Hear Comments and Consider Adoption of the Risk-Based Capital (RBC) Preamble  
   —Commissioner David Altmaier (FL)  Attachment Ten
7. Hear Comments on Exposed Referrals—Commissioner David Altmaier (FL)
   a. NAIC Designations for Schedule D, Part 2, Section 2 – Common Stocks
   b. RBC Charges for Funds and Comprehensive Funds
      i) American Academy of Actuaries (Academy)
      ii) American Council of Life Insurers (ACLI) and North American
          Securities Valuation Association (NASVA)
      iii) Anderson Insights
      iv) Everest Reinsurance Company
      v) Payden & Rygel
      vi) Vanguard Institutional Investor Group
      vii) Additional Comment Letters from the Valuation of Securities (E) Task Force
          Fall 2018 Exposure are on available on the Task Force Page
          https://content.naic.org/sites/default/files/national_meeting/Comments%20to%20VOSTF%20Exposure%20of%20Bond%20Fund%20Proposal%20Fall%202018.pdf
   c. Structured Notes
      i) ACLI and NASVA

8. Discuss Any Other Matters Brought Before the Task Force—Commissioner David Altmaier (FL)

9. Adjournment

W:\National Meetings\2019Fall\TF\CapAdequacy\ Dec.8_Agenda_CapAd TF
The Capital Adequacy (E) Task Force met via conference call Oct. 8, 2019. The following Task Force members participated:

David Altmaier, Chair (FL); Todd E. Kiser, Vice Chair, represented by Jake Garn (UT); Ricardo Lara represented by Perry Kupferman (CA); Andrew N. Mais represented by Wanchin Chou (CT); Stephen C. Taylor represented by Philip Barlow (DC); Doug Ommen represented by Mike Yanacheak (IA); Robert H. Muriel represented by Kevin Fry (IL); Vicki Schmidt represented by Tish Becker (KS); Chlora Lindley-Myers (MO); Marlene Caride represented by Diana Sherman (NJ); John G. Franchini represented by Anna Krylova (NM); Jillian Froment represented by Dale Bruggeman (OH); Glen Mulready represented by Joel Sander (OK); Elizabeth Kelleher Dwyer represented by Jack Broccoli (RI); Kent Sullivan represented by Jamie Walker (TX); Mike Kreidler represented by Patrick McNaughton (WA); and Mark Afable represented by Randy Milquet (WI). Also participating was Jim Everett (NY).

1. **Adopted its Sept. 18 Minutes**

Director Lindley-Myers made a motion, seconded by Mr. Bruggeman, to adopt the Task Force’s Sept. 18 minutes (Attachment One) and 2020 proposed charges (see NAIC Proceedings – Fall 2019, Financial Condition (E) Committee Attachment One-A). The motion passed unanimously.

2. **Exposed its Referrals**

Commissioner Altmaier said the Task Force has received numerous referrals dating back to August 2018. The referrals relate to investments and various other groups under the Financial Condition (E) Committee, such as the Statutory Accounting Principles (E) Working Group and the Valuation of Securities (E) Task Force. The referrals indicate that some changes to the way certain investments are treated either from an accounting standpoint or an investment standpoint which may or may not result in necessary changes to the risk-based capital (RBC). Due to the volume of referrals, it is apparent that some can be grouped together, and the purpose of this call is to discuss a pathway forward. Items 2a through 2e, which correspond to attachments 2–6, are open for questions or discussion today. These items will be exposed for a 30-day public comment period ending Nov. 8 to receive input on how to approach each one of the referrals.

Commissioner Altmaier added that this is an opportunity for interested stakeholders to provide feedback to the Capital Adequacy (E) Task Force members on how these referrals could help state insurance regulators identify insurance companies that might have issues from a capital standpoint and how the RBC formula can be more efficient to meet that goal by updating investment risk factors within the formula.

a. **NAIC Designations for Schedule D, Part 2-Section 2 – Common Stocks** — Mr. Fry said the Valuation of Securities (E) Task Force did look at this and item C – Comprehensive Funds, which are somewhat related, and he said the framework already allows for this investment through the Statement of Statutory Accounting Principles (SSAP) No. 26R—Other Admitted Assets; but was written a long time ago, and these investments are allowed on Schedule D Part 1 and are given the same factor as bonds. He added that in the life and fraternal RBC, these funds are reported on Schedule BA and are given the same bond treatment. He believes that these funds should be given a designation similar to bonds instead of a factor similar to common stock, which is a flat factor charge of 15% for property/casualty (P/C) and health. He added that re-evaluating the funds would be a lengthy process and a quicker way of updating would be to treat it like a bond.

Commissioner Altmaier added that some of these referrals are similar to each other; although listed separately on the agenda, they can be lumped into one comment letter to the Capital Adequacy (E) Task Force. Mr. Barlow added that the investments should be evaluated first to determine the appropriate charge, and he disagrees that just giving them the bond factor is wrong. He added, especially when the sole purpose of this referral is to change the RBC factor, he disagrees with changing the factor firsts and then evaluating what it should be later. He stressed that the analysis to determine the appropriate risk charge should be done first, and he stated that it is very clear that the proposal’s objective is to change the RBC charge. He asked for clarification on the exposure and whether these referrals will apply to all RBC formulas. Commissioner Altmaier said for now, they will remain at the Task Force level; after the comments are reviewed, the Task Force will determine the appropriate direction, whether that will be to refer them to
all RBC working groups for further review or not. He added that if any of the proposal moves beyond this exposure period, there will be other opportunities for further discussion on methodology and what changes should occur in the formulas.

b. Mutual Funds – Commissioner Altmaier pointed out that this referral was received some time ago and was also directed to the Valuation of Securities (E) Task Force. Julie Gann (NAIC) said the Statutory Accounting Principle (E) Working Group already adopted this change based on feedback received during its exposure period and determined that it was previously included in SSAP No. 30R—Unaffiliated Common Stock and inadvertently excluded mutual funds reported on the common stock schedule. She added that a referral to the Blanks (E) Working Group to include designations for mutual funds and include them in the top 10 exposures based on diversified and non-diversified funds. Hearing no comments, the Capital Adequacy (E) Task Force will consider this referral complete.

c. Comprehensive Funds – Commissioner Altmaier said both of these referrals came from the Valuation of Securities (E) Task Force regarding funds that predominately hold bonds. Charles Therriault (NAIC) said the Securities Valuation Office (SVO) is charged with evaluating credit risk and assigning a designation based on that risk by looking into the required payments within the investment and what the source of those payments are (e.g., for a typical corporate bond, the source of those payments are the operating business entity whose financial statements are reviewed and analyzed along with the bond’s legal agreement, and an opinion is formed based on the likelihood that the contractual payments will be met; that opinion is provided by assigning a designation). Funds are a portfolio of individual bonds, and the portfolio is the source of those payments. For example, if an investor holds 10 bonds directly, those 10 bonds would be exposed to a credit risk; therefore, the fund would be exposed to the same level of credit risk, assuming they all have the same market value change and credit events. The substance of the risk has not changed, just the legal form. The weighted average ratings factor (WARF) is applied to each underlying investment and reflects the relative risk of each of the delineations and credit risk. A bonds with an A+ rating would get a factor of roughly 100. If compared to another bond with a rating of B+, it would get a factor of 50, 858 times the level of risk; and through the application of these rating factors to the underlying investments they are aggregated up to essentially become an aggregate fund, the risk level, which is why there is a lot of comfort in terms of the analysis process and how NAIC designations are assigned to this portfolio. Analysis would be difficult based on the number of different classes of investment included in a fund. Mr. Everett said the first thing to consider is how many mutual funds and exchange-traded funds (ETFs) are being reported on Schedule D Part 2 Section 2. Back in the time when ETFs were first given bond treatment, there were only two or three funds. Currently, these funds are receiving a 15% charge, same as common stock for the health and P/C RBC. It would be helpful to know what the growth rate is and what amount is being talked about. There are definitely more funds today, and if the market is much larger and the percentage of funds are at an increase, then it would seem that the best place to catch hold of it, if dealing with credit default risk and averaging ratings as opposed to averaging percentages of default, it would be helpful to capture that information on a separate schedule. Mr. Everett reiterated that it is important to understand the trend before factors are changed and its impact to RBC. Commissioner Altmaier agreed and asked that NAIC staff provide any analysis already collected on these funds. Mr. Barlow said it would also be helpful to find out where in the schedule these funds are currently reported; assuming that the volume is significant, there might be some benefit in either creating a specific schedule or an identifier to put all these funds together. He added that in a lot of cases, companies are misreporting and examiners have missed things or are not quite sure where they should be reported. If a separate schedule for these funds were added, only then could the real exposure be seen and the different funds and individual investments be differentiated. Commissioner Altmaier said the Capital Adequacy (E) Task Force would welcome any feedback from the interested stakeholders on the referral or on any of the comments from the state insurance regulators’ discussion, these should be included in comments during the 30-day public comment period.

d. Supplemental Investment Risk Interrogatories (SIRI) – Ms. Gann explained that this was exposed at the Summer National Meeting, and the Statutory Accounting Principles (E) Working Group will discuss comments received during the Fall National Meeting. Pending comments, this proposal may not be finalized at that time. Her summary stated that if an equity exposure is diversified, open-end diversified funds would not necessarily have to be looked into to identify all exposures for aggregation. However, if a closed end fund is not diversified or an open-end fund is not diversified, then the exposure would need to be looked through to identify what the exposures are, and it would need to aggregate those with other individual exposures. Essentially, it is preventing the inclusion of a fund environment to prevent identifying key exposures for an insurance entity. It was referred over simply because a comment was received that there could potentially be an RBC impact for this with regard to concentration risk. Commissioner Altmaier said this referral will be moved to the top of the list, exposed for a 30-day public comment period and specifically,
and he asked that any comments regarding its impact to RBC that the Capital Adequacy (E) Task Force should provide to the Working Group be provided within.

e. Structured Notes – Commissioner Altmaier said this referral specified specific revisions to the Statutory Accounting Principles SSAP No. 2R—Cash, Drafts, and Short-term Investments, SSAP No. 26R—Bonds; SSAP No. 43R—Loan-Backed and Structured Securities and SSAP No. 86—Derivatives that affect structure notes, and revisions were adopted with a Dec. 31, 2019, effective date. The Capital Adequacy (E) Task Force will expose this referral for a 30-day public comment period to receive any feedback or objections to the changes.

Commissioner Altmaier reiterated that the referral for mutual funds is considered completed, the SIRI referral is open for comments by the Statutory Accounting Principles (E) Working Group, and they will allow the Capital Adequacy (E) Task Force until mid-November to provide comments. The common stocks, comprehensive funds, and structured notes referrals will be exposed for a 30-day public comment period asking specifically if these referrals affect RBC, what resources should be used to analyze the investments, and how the analysis should be done.

3. Discussed Working Agenda

Commissioner Altmaier said the only updates to the working agenda will be to prioritize the referrals as a 3- low priority during the exposure period.

Having no further business, the Capital Adequacy (E) Task Force adjourned.
The Health Risk-Based Capital (E) Working Group met Dec. 8, 2019. During this meeting, the Working Group:

1. Adopted its Oct. 21 and Sept. 9 minutes, which included the following action:
   a. Reported that the Working Group met Oct. 10 in regulator-to-regulator session pursuant to paragraph 3 (specific companies, entities or individuals) of the NAIC Policy Statement on Open Meetings.
   b. Exposed the Health Test Proposal to the Health Risk-Based Capital (E) Working Group and the Life Risk-Based Capital (E) Working Group for a 30-day comment period ending Nov. 20.
   c. Agreed to move forward with field-testing of the health test.
   d. Referred the Long-Term Care HMO Guaranty Fund Memo to the Capital Adequacy (E) Task Force.
   f. Heard comments on the excessive growth charge.
   g. Heard comments on the draft health bond structure.
   h. Discussed the managed care credit.
   i. Received an update from the Health Test Ad Hoc Group.

2. Discussed the draft health bond structure, specifically how to address if investment income is included in the current health formula; the proposed factor of 0.1% for Aaa and Aa1 investment grade bonds; and the inclusion of the bond portfolio adjustment within the factors for speculative grade bonds. The Working Group agreed to continue this discussion.

3. Heard comments on the Health Test Language Proposal from the American Council of Life Insurers (ACLI). The Working Group agreed to send the comments to the Health Test Ad Hoc Group for further consideration in its discussions related to the health test language.


5. Adopted updates to its 2020 working agenda.

6. Received an update from the Excessive Growth Charge Ad Hoc Group regarding its plan to move forward on the referral from the Operational Risk (E) Subgroup to evaluate the current excessive growth and to consider possible changes to the charge.

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The Life Risk-Based Capital (E) Working Group met Dec. 7, 2019. During this meeting, the Working Group:

1. Adopted its Oct. 23 and Summer National Meeting minutes, which included the following action:
   a. Rejected the proposal to update the risk-based capital (RBC) charge for unaffiliated common stock supporting long-horizon contractual commitments.
   b. Exposed the memorandum on potential further work on life growth operational risk for public comment.
   c. Adopted its July 22, June 24, June 17, June 6, May 13, April 26, and Spring National Meeting minutes.
   d. Adopted the reports of the Variable Annuities Capital and Reserve (E/A) Subgroup and the Longevity Risk (A/E) Subgroup.

2. Adopted the report of the Longevity Risk (A/E) Subgroup, including adoption of its Nov. 25, Nov. 4, Oct. 7, Sept. 30 and Sept. 18, minutes, which included the following action:
   b. Adopted the Subgroup’s recommendation to the Life Risk-Based Capital (E) Working Group for a longevity risk charge.

3. Exposed the Longevity Risk (A/E) Subgroup’s recommendation for a longevity risk charge along with the Academy’s alternative that includes covariance for a 60-day public comment period. The Working Group also agreed to scope out longevity reinsurance transactions for now with direction to the Subgroup to continue to work on this aspect.


5. Received an update from NAIC staff on the work being done on economic scenario generators.

6. Discussed comments received on life growth risk.
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The Property and Casualty Risk-Based Capital (E) Working Group met Dec. 8, 2019. During this meeting, the Working Group:

1. Adopted its Nov. 8 minutes, which included the following action:
   a. Adopted the Catastrophe Risk (E) Subgroup’s Summer National Meeting minutes.
   b. Adopted its Summer National Meeting minutes.
   c. Adopted proposal 2019-11-P (Clarification to Instructions Regarding Lloyd’s of London) and the 2019 reporting guideline.
   d. Adopted proposal 2019-12-P (Remove PR038 Adjustment for Reinsurance Penalty).
   e. Exposed the 2019 catastrophe event lists.
   f. Heard updates from the American Academy of Actuaries (Academy) on reviewing the underwriting risk components.
   g. Discussed the appropriate factor of unrated uncollateralized recoverables.
   h. Discussed the factor of using the aggregate exceedance probability (AEP) and occurrence exceedance probability (OEP) basis.

2. Adopted the report of the Catastrophe Risk (E) Subgroup, which included the following action:
   a. Adopted its Nov. 8 minutes.
   c. Heard a presentation from the Academy on “Wildfire: Lessons Learned.”
   d. Heard a presentation from the Academy on “Actuaries Climate Index (ACI) and Actuaries Climate Risk Index (ACRI).”

3. Exposed proposal 2018-19-P (Vulnerable 6 or Unrated Risk Charge) for a 45-day public comment period ending Jan. 21, 2020. The purpose of this proposal is to modify the property/casualty (P/C) risk-based capital (RBC) instruction to reflect the factors for all uncollateralized reinsurance recoverables from unrated reinsurers to be the same for authorized, unauthorized, certified and reciprocal reinsurance.

4. Discussed the 2020 P/C RBC working agenda.

5. Discussed the possibility of using the NAIC as a centralized location for reinsurer designations.

6. Discussed the possible treatment of the R3 related to the runoff companies and captive companies.


8. Discussed the Restructuring Mechanisms (E) Subgroup’s charge related to the P/C RBC formula. The Working Group will closely monitor the development of the Subgroup related to the possibility of recommending changes to the RBC formula to better assess the minimum surplus requirements for companies in runoff.
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# Working Agenda Items for Calendar Year 2019

## Ongoing Items – Life RBC

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<tr>
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<th>Owner</th>
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<th>Date</th>
<th>Working Agenda Item</th>
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<tr>
<td>1</td>
<td>Life RBC</td>
<td>Ongoing</td>
<td>Ongoing</td>
<td>Make technical corrections to Life RBC instructions, blank and/or methods to provide for consistent treatment among asset types and among the various components of the RBC calculations for a single asset type.</td>
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</table>
| 2  | Life RBC          | 1       | 2019 or later | A. Evaluate the overall effectiveness of the C3 Phase 2 and AG 43 methodologies by conducting an in-depth analysis of the models, modeling assumptions, processes, supporting documentation and results of a sample of companies writing variable annuities with guarantees and to make recommendations to the Capital Adequacy Task Force or Life Actuarial Task Force on any changes to the methodologies to improve their overall effectiveness.  
B. Develop and recommend changes to C-3 Phass II and AG 43 that implement, for 2018 adoption, the Variable Annuities Framework for Change. | CATF   | Being addressed by the Variable Annuities Capital and Reserve (E/A) Subgroup |
| 3  | Life RBC          | 1       | 2019 or later | Provide recommendations for recognizing longevity risk in statutory reserves and/or RBC, as appropriate. | New Jersey | Being addressed by the Longevity (E/A) Subgroup |

## Carry-Over Items Currently being Addressed – Life RBC

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<tr>
<td>4</td>
<td>Life RBC</td>
<td>1</td>
<td>2019 or later</td>
<td>Update the current C-3 Phase 1 or C-3 Phase II methodology to include indexed annuities</td>
<td>AAA</td>
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<td>5</td>
<td>Life RBC</td>
<td>2</td>
<td>2019 or later</td>
<td>Develop guidance, for inclusion in the proposed NAIC contingent deferred annuity (CDA) guidelines, for states as to how current regulations governing risk-based capital requirements, including C-3 Phase II, should be applied to contingent deferred annuities (CDAs). Recommend a process for reviewing capital adequacy for insurers issuing CDAs and prepare clarifying guidance, if necessary, due to different nomenclature then used with regard to CDAs. The development of this guidance does not preclude the Working Group from reviewing CDAs as part of any ongoing or future charges where applicable and is made with the understanding that this guidance could change as a result of such a review.</td>
<td>10/21/13 Referral from A Committee</td>
<td>It is important to consider the implications of work being done by the CDA and VA Issues Working Groups to ensure consistency in addressing these charges. The Working Group is monitoring the progress of that work.</td>
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<td>6</td>
<td>Life RBC</td>
<td>1</td>
<td>2019</td>
<td>Review and evaluate company submissions for the RBC Shortfall schedule and corresponding adjustment to Total Adjusted Capital.</td>
<td>10/16/2015</td>
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<tr>
<td>7</td>
<td>Life RBC</td>
<td>1</td>
<td>2019</td>
<td>Review and evaluate company submissions for the Primary Security Shortfall schedule and corresponding adjustment to Authorized Control Level.</td>
<td>10/16/2015</td>
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<td>8</td>
<td>Life RBC</td>
<td>1</td>
<td>2019</td>
<td>Continue consideration impacts and modifications necessary due to the Federal Tax Cuts and Jobs Act and develop guidance for users of RBC on those impacts.</td>
<td>3/24/2018</td>
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<tr>
<td>9</td>
<td>Life RBC</td>
<td>1</td>
<td>2019</td>
<td>Determine if any adjustment is needed to the XXX/AXXX RBC Shortfall calculation to address surplus notes issued by captives.</td>
<td>11/1/17 Referral from the Reinsurance (E) Task Force</td>
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## New Items - Life RBC

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<tr>
<td>10</td>
<td>Life RBC</td>
<td>1</td>
<td>2019</td>
<td>Address changes needed due to elimination of the fraternal annual statement blank.</td>
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<td>11</td>
<td>Life RBC</td>
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<td>2019</td>
<td>Determine if any adjustment is needed due to the changes made to the Life and Health Guaranty Association Model Act, Model #520.</td>
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<tr>
<td>12</td>
<td>Life RBC</td>
<td>1</td>
<td>2019</td>
<td>Determine if any adjustment is needed to the reinsurance credit risk in light of changes related to collateral and the changes made to the property RBC formula.</td>
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## Carry-Over Items Currently being Addressed – P&C RBC

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## Capital Adequacy (E) Task Force
### Working Agenda Items for Calendar Year 2019

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<tr>
<td>13</td>
<td>Cat Risk SG</td>
<td>1</td>
<td>Year-end 2020</td>
<td>Continue development of RBC formula revisions to include a risk charge based on catastrophe model output. a) Evaluate other catastrophe risks for possible inclusion in the charge - determine whether to recommend developing charges for any additional perils, and which perils or perils those should be. b) Evaluate the AEP vs OEP factors.</td>
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<tr>
<td>14</td>
<td>P&amp;C RBC WG</td>
<td>1</td>
<td>Year-end 2020 or later</td>
<td>Evaluate a) the current growth risk methodology whether it is adequately reflects both operational risk and underwriting risk; b) the premium and reserve based growth risk factors either as a stand-alone task or in conjunction with the ongoing underwriting risk factor review with consideration of the operational risk component of excessive growth; c) whether the application of the growth factors to NET proxies adequately accounts for growth risk that is ceded to reinsurers that do not trigger growth risk in their own right.</td>
<td></td>
<td>Refer from Operational Risk Subgroup 1) Sent a referral to the Academy on 6/14/18 conference call.</td>
<td>1/25/2018</td>
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<td>15</td>
<td>P&amp;C RBC WG</td>
<td>1</td>
<td>Year-end 2020</td>
<td>Evaluate the impact to RBC on a) Pre-Tax vs. After Tax; b) Tax reform on Total Adjusted Capital</td>
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<td>16</td>
<td>P&amp;C RBC WG</td>
<td>1</td>
<td>2020 Summer Meeting or later</td>
<td>Continue development of RBC formula revisions based on the Covered Agreement: a) consider eliminating the different treatment of uncollateralized reinsurance recoverable from authorized versus unauthorized, unrated reinsurers; b) consider whether the factor for uncollateralized, unrated reinsurers, runoff and captive companies should be adjusted; c) Evaluate the possibility of using NAIC as a centralized location for reinsurance designations.</td>
<td></td>
<td>12/5/19 - The WG exposed Proposal 2018-19-P (Vulnerable 6 or unrated risk charge) for a 45-day exposure period.</td>
<td>8/4/2018</td>
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<td>17</td>
<td>P&amp;C RBC WG</td>
<td>1</td>
<td>Year-end 2021 or later</td>
<td>Evaluate the proposed changes from the Affiliated Investment Ad Hoc Group related to P/C RBC Affiliated Investments</td>
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<tr>
<td>18</td>
<td>P&amp;C RBC WG</td>
<td>1</td>
<td>2021 Summer Meeting or later</td>
<td>Continue working with the Academy to review the methodology and revise the underwriting (Investment Income Adjustment, Loss Concentration, LOB UW risk) charges in the PRBC formula as appropriate.</td>
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**New Items – P&C RBC**

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<td>19</td>
<td>Cat Risk SG</td>
<td>1</td>
<td>Year-end 2020 or later</td>
<td>Evaluate the possibility of allowing additional third party models to calculate the cat model losses</td>
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<td>12/6/2019</td>
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**Ongoing Items – Health RBC**

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</table>
## CAPITAL ADEQUACY (E) TASK FORCE

### WORKING AGENDA ITEMS FOR CALENDAR YEAR 2019

<table>
<thead>
<tr>
<th>#</th>
<th>Owner</th>
<th>2020 Priority</th>
<th>2020 Priority Date</th>
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<tbody>
<tr>
<td>21</td>
<td>Health RBC WG</td>
<td>3</td>
<td>2020</td>
<td>Year-end 2021 RBC or later</td>
<td>Discuss and monitor the development of federal level programs and actions and the potential impact of these changes to the HRBC formula: - Development of the state reinsurance programs; - Association Health Plans; - Cross-border sales</td>
<td>HRBCWG</td>
<td>Discuss and monitor the development of federal level programs and the potential impact on the HRBC formula.</td>
<td>1/11/2018</td>
</tr>
<tr>
<td>22</td>
<td>Health RBC WG</td>
<td>3</td>
<td>2020</td>
<td>Year-End 2023 RBC or Later</td>
<td>Consider changes for stop-loss insurance or reinsurance.</td>
<td>AAA Report at Dec. 2006 Meeting</td>
<td>(Based on Academy report expected to be received at YE-2016) 2016-17-CA</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>Health RBC WG</td>
<td>2</td>
<td>2020</td>
<td>Year-end 2023 RBC or later</td>
<td>Review the individual factors for each health care receivables line within the Credit Risk H3 component of the RBC formula.</td>
<td>HRBC WG</td>
<td>Adopted 2016-06-H Rejected 2019-04-H</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Health RBC WG</td>
<td>1</td>
<td>2020</td>
<td>Year-end 2022 or later</td>
<td>Establish an Ad Hoc Group to review the Health Test and annual statement changes for reporting health business in the Life and P/C Blanks</td>
<td>HRBCWG</td>
<td>Evaluate the applicability of the current Health Test in the Annual Statement instructions in today's health insurance market. Discuss ways to gather additional information for health business reported in other blanks.</td>
<td>8/4/2018</td>
</tr>
<tr>
<td>25</td>
<td>Health RBC WG</td>
<td>1</td>
<td>2020</td>
<td>Year-end 2020 RBC or later</td>
<td>Review the Managed Care Credit calculation in the Health RBC formula - specifically Category 2a and 2b.</td>
<td>HRBCWG</td>
<td>Review the Managed Care Category and the credit calculated, more specifically the credit calculated when moving from Category 0 &amp; 1 to 2a and 2b.</td>
<td>12/3/2018</td>
</tr>
<tr>
<td>26</td>
<td>Health RBC WG</td>
<td>1</td>
<td>2020</td>
<td>Year-end 2020 or later</td>
<td>Review referral letter from the Operational Risk (E) Subgroup on the excessive growth charge and the development of an Ad Hoc group to charge.</td>
<td>HRBCWG</td>
<td>Review if changes are required to the Health RBC</td>
<td>4/7/2019</td>
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### Ongoing Items – Task Force

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<tbody>
<tr>
<td>27</td>
<td>CADTF</td>
<td>2</td>
<td>2018</td>
<td>Affiliated Investment Subsidiaries Referral</td>
<td>Ad Hoc Group formed Sept. 2016</td>
<td>Ad Hoc group will provide periodic updates on their progress.</td>
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### Carry-Over Items not Currently being Addressed – Task Force

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<th>#</th>
<th>Owner</th>
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<tbody>
<tr>
<td>28</td>
<td>CADTF</td>
<td>2</td>
<td>2021</td>
<td>Receivable for Securities factor</td>
<td></td>
<td>Consider evaluating the factor every 3 years. (2018, 2021, 2024 etc.)</td>
<td></td>
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<tr>
<td>29</td>
<td>CADTF</td>
<td>3</td>
<td>2020</td>
<td>NAIC Designation for Schedule D, Part 2 Section 2 - Common Stocks</td>
<td>Referral from SAPWG 8/13/2018</td>
<td>Exposed for a 30-day Comment period ending 11/8/2019</td>
<td>10/11/2018</td>
</tr>
<tr>
<td>30</td>
<td>CADTF</td>
<td>3</td>
<td>2020</td>
<td>Foreign Mutual Funds</td>
<td>Referral from SAPWG 11/27/2018</td>
<td>On the CADTF 10/8/19 conf. call SAPWG indicated that this update/change is now complete</td>
<td>2/19/2019</td>
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### New Items – Task Force

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<th>Date</th>
<th>Item</th>
<th>Source</th>
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© 2019 National Association of Insurance Commissioners
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<th>Working Agenda Item</th>
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<tr>
<td>30</td>
<td>CADTF</td>
<td>3</td>
<td>2020 or Later</td>
<td>Structured Notes</td>
<td>Referral from SAPWG April 16, 2019</td>
<td>Exposed for a 30-day Comment period ending 11/8/2019</td>
<td>8/4/2019</td>
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<tr>
<td>31</td>
<td>CADTF</td>
<td>3</td>
<td>2020 or Later</td>
<td>SIRI – Line 13 Equity Interests</td>
<td>Referral from SAPWG 8/12/2019</td>
<td>Exposed for a 30-day Comment period ending 11/8/2019 No comments were received during the exposure period. The Task Force will consider this referral completed without further action.</td>
<td>10/8/2019</td>
</tr>
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</table>

**Carry-Over Items Currently being Addressed – Task Force**

<table>
<thead>
<tr>
<th>No.</th>
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<tbody>
<tr>
<td>31</td>
<td>CADTF</td>
<td>3</td>
<td>2020</td>
<td>Comprehensive Fund Review for investments reported on Schedule D Pt 2 Sn2</td>
<td>Referral from VOSTF 9/21/2018</td>
<td>Discussed during Spring Mtg. NAIC staff to do analysis. Exposed for a 30-day comment period ending 11/8/2019</td>
<td>11/16/2018</td>
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<tr>
<td>32</td>
<td>CADTF</td>
<td>2</td>
<td>2020 or Later</td>
<td>XXX/AXXX Captive Reinsurance RBC Shortfall</td>
<td>Referral from Reinsurance Task Force /RITF</td>
<td>Referred to Life RBC WG for consideration and comment</td>
<td>11/1/2017</td>
</tr>
<tr>
<td>33</td>
<td>CADTF</td>
<td>2</td>
<td>2020 or Later</td>
<td>Payout Annuities for RBC</td>
<td>Referral from Allstate and IL DOI</td>
<td>Referred to Life RBC WG for consideration and comment</td>
<td>3/25/2018</td>
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<tr>
<td>34</td>
<td>CADTF</td>
<td>2</td>
<td>2020 or Later</td>
<td>Guaranty Association Assessment Risk</td>
<td>Referral from Receivership and Insolvency (E) Task Force 5/1/2018</td>
<td>Referred to the Life RBC WG and Health RBC WG for consideration and comment.</td>
<td>6/30/2018</td>
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**Investment Risk-Based Capital Working Group**

**Carry-Over Items Currently being Addressed – Investment RBC**

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<th>No.</th>
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</thead>
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<tr>
<td>35</td>
<td>Investment RBC WG</td>
<td>1</td>
<td>2020 or later</td>
<td>The Solvency Modernization Initiative (EX) Task Force and the Capital Adequacy (E) Task Force have been discussing reform of the RBC formulae for life, property/casualty and health insurers. The Working Group recommends a comprehensive review of RBC, including a review of whether all RBC formulae should have greater granularity.</td>
<td>Rating Agency WG Referral March 2010</td>
<td></td>
<td></td>
</tr>
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</table>

**Carry-Over Items not Currently being Addressed – Investment RBC**

<table>
<thead>
<tr>
<th>No.</th>
<th>Owner</th>
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<th>Working Agenda Item</th>
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<tr>
<td>36</td>
<td>Investment RBC WG</td>
<td>2</td>
<td>Year-End 2021</td>
<td>Consideration should be given to recalibrate the RBC formulae to require different levels of capital for municipal, corporate and structured securities.</td>
<td>Rating Agency WG Referral March 2010</td>
<td></td>
<td></td>
</tr>
<tr>
<td>37</td>
<td>Investment RBC WG</td>
<td>1</td>
<td>Year-End 2021</td>
<td>Ensure that the RBC formulae, for all business types, for common stock and bonds are consistent with respect to statistical safety levels, modeling assumptions, where appropriate.</td>
<td>CADTF</td>
<td>Consolidated with items #42, 43 and 44 from the 2015 Working Agenda</td>
<td>2/10/2015 8/17/2015</td>
</tr>
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</table>
### Working Agenda Items for Calendar Year 2019

<table>
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<tr>
<th>#</th>
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<th>Priority</th>
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<th>Working Agenda Item</th>
<th>Source</th>
<th>Comments</th>
<th>Date Added to Agenda</th>
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</thead>
<tbody>
<tr>
<td>38</td>
<td>Investment RBC WG</td>
<td>2</td>
<td>Year-End 2021</td>
<td>Consider modifications for investment risk to capture more than credit risk to place less reliance on the rating agencies. Consider modifications to better identify liquidity and asset concentration.</td>
<td>CDS WG referrals</td>
<td></td>
<td></td>
</tr>
<tr>
<td>39</td>
<td>Investment RBC WG</td>
<td>2</td>
<td>Year-End 2021</td>
<td>The asset valuation reserve (AVR) establishes a reserve to offset potential credit-related investment losses on all invested asset categories. Similar to RBC,</td>
<td>Rating Agency WG Referral March</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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MEMORANDUM

TO: Commissioner David Altmaier (FL), Chair, Capital Adequacy (E) Task Force
FROM: Patrick McNaughton (WA), Chair, Health Risk-Based Capital (E) Working Group
DATE: October 21, 2019
RE: Recommendation Regarding Risk-Based Capital Charge for Guaranty Association Assessment Risk

On Sept. 21, 2018 the Health Risk-Based Capital (E) Working Group received a request from the Capital Adequacy (E) Task Force to review the referral letter regarding adopted amendments to the Life and Health Insurance Guaranty Association Model Act, Model #520. The referral outlined significant amendments to Model #520, including: 1) broadening the assessment base for long-term care insurance (LTCI) insolvencies to include both life and health insurers and splitting the assessment 50%/50% between the life and health insurers; 2) clarifying the guaranty associations’ coverage of LTCI; and 3) including health maintenance organizations (HMOs) as members of the guaranty association, similar to other health insurers. The referral letter requested that the Task Force consider if changes were warranted to the health RBC formula in light of the changes made to Model #520.

Based upon our review of existing Guaranty Fund Assessment Risk charge under the H4-Business Risk component, a charge of .5% is applied to direct earned premiums (as reported in Schedule T) in any state in which the reporting entity is subject to guaranty fund assessments. Based on the current instructions and reporting the Working Group does not believe that modifications to the Health Risk-Based Capital formula are required for the change to Model #520.

The recommendation above does not preclude the Working Group from potential changes to long-term care or the business risk component charge in the future.

If you have any questions regarding this memorandum, please contact me at PatM@oiw.wa.gov or Crystal Brown (NAIC) at cbrown@naic.org.
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The proposed changes clarify the reinsurance recoverable from individual syndicates of Lloyds’ of London that are covered under the Lloyd’s Central Fund may utilize the lowest financial strength group rating received from an approved rating agency.

REASON OR JUSTIFICATION FOR CHANGE **

Upon review of 2018 Schedule F Part 3 filings, it has been observed that many filers reported reinsurance recoverable amounts due from Lloyd’s of London Syndicates as being NAIC 6-Unrated; and therefore, subject to the highest credit risk charge.

Additional Staff Comments:

8-3-19 The PCRBCWG exposed for comment until 9-3-19
11-8-19 This proposal has been adopted at the Joint Catastrophe Risk Subgroup and Property/Casualty Risk-Based Capital Working Group conference call on Nov. 8.
PR012 - Credit Risk for Receivables

Reinsurance Recoverables

The calculation of the credit risk charge for reinsurance recoverables is detailed in Schedule F Part 3 Columns 28 through 36 of the Property/Casualty Annual Statement. This calculation is performed at the transaction level and those results are then summed to determine the charge. Reinsurance balances receivable on reinsurance ceded to non-affiliated companies (excluding certain pools) and to alien affiliates are subject to the credit risk-based capital charge. The following types of cessions are exempt from this charge:

- Cessions to State Mandated Involuntary Pools and Associations or to Federal Insurance Programs.
- This category includes all federal insurance programs [e.g., National Flood Insurance Program (NFIP), Federal Crop Insurance Corporation (FCIC), etc., all state mandated residual market mechanisms and the National Council on Compensation Insurance (NCCI).
- Cessions to U.S. Parents, Subsidiaries and Affiliates.

The categories above are automatically excluded from the data that is calculated in Schedule F Part 3 of the Annual Statement.

Since the Annual Statement requires the collectability of reinsurance balances be considered via the reinsurance penalty, the appropriate balances must be offset by any liability that has been established for this purpose. The amount from Page 3, Line 16 should be allocated to the appropriate (re)insurers listed on Schedule F. The total amount recoverable from reinsurers less any applicable reinsurance penalty is multiplied by 120% to stress the recoverable balance. The total of reinsurance payable and/or funds held amounts (not in excess of the stressed recoverable) are applied as offsets to arrive at the stressed net recoverable.

Since there are different reinsurance credit risk factors for collateralized and uncollateralized reinsurance recoverables, the stressed net recoverable should be offset by any available collateral, such as letters of credit, multiple beneficiary trusts, and single beneficiary trusts and other allowable offsets (not in excess of the stressed net recoverable). The collateralized amounts are derived from Schedule F Part 3 Column 32 and the uncollateralized amounts are derived from Column 33.

The risk-based capital for the various credits (including collateral offsets where applicable) taken for reinsurance may not be less than zero even if the amount reported or the amount net of offsets is negative.

The factor for reinsurance recoverables (paid and unpaid less any applicable reinsurance penalty) due from a particular reinsurer is determined based on that reinsurer’s financial strength rating assigned on a legal entity basis.

For the purpose of the credit risk-based capital charge, the equivalent rating category assigned will correspond to current financial strength rating received from an approved rating agency as outlined in the table below. Ratings shall be based on interactive communication between the rating agency and the assuming insurer and shall not be based solely on publicly available information. If the reinsurer is unauthorized and does not have at least one financial strength rating, it should be assigned the “Vulnerable 6 or Unrated Unauthorized” equivalent rating. If the reinsurer is authorized and does not have at least one financial strength rating, it should be assigned the “Unrated Authorized Reinsurers” equivalent rating. Amounts recoverable from unrated voluntary pools should be assigned the “Secure 3” equivalent rating. An authorized association including incorporated and individual unincorporated underwriters or a member thereof [e.g. individual authorized syndicates of Lloyds’ of London that are backed by the Central Fund] may utilize the lowest financial strength group rating received from an approved rating agency. The table below shows the R3 reinsurer equivalent rating categories and corresponding factors for A.M. Best, Standard and Poor’s, Moody’s and Fitch ratings.
Proposed Guidance Statement:

Upon review of 2018 Schedule F Part 3 filings, it has been observed that many filers reported reinsurance recoverable amounts due from Lloyd’s of London Syndicates as being NAIC 6-Unrated; and therefore subject to the highest credit risk charge.

However, the RBC Instructions for PR012 - Credit Risk for Receivables provides that: “An authorized association including incorporated and individual unincorporated underwriters or a member thereof may utilize the lowest financial strength group rating received from an approved rating agency.” This instruction is applicable to reinsurance recoverable from individual syndicates of Lloyd’s of London that are covered under the Lloyd’s Central Fund; and are therefore eligible to be treated as rated for the purposes of PR012 and the R3 Credit Risk component of RBC. This treatment is consistent with the NAIC Credit for Reinsurance Model Law and Regulation concerning applicable NAIC ratings designations for the purpose of determining reduced collateral requirements.
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Capital Adequacy (E) Task Force

RBC Proposal Form

DATE: 4/11/19

CONTACT PERSON: Eva Yeung
TELEPHONE: 816-783-8407
EMAIL ADDRESS: eyeung@naic.org
ON BEHALF OF: P/C RBC (E) Working Group
NAME: Tom Botsko
TITLE: Chair
AFFILIATION: Ohio Department of Insurance
ADDRESS: 50 West Town Street, Suite 300
Columbus, OH 43215

FOR NAIC USE ONLY
Agenda Item # 2019-12-P
Year 2020

DISPOSITION
[ ] ADOPTED
[ ] REJECTED
[ ] DEFERRED TO
[ ] REFERRED TO OTHER NAIC GROUP
[ ] EXPOSED 8-3-19
[ ] OTHER (SPECIFY)  ________________

IDENTIFICATION OF SOURCE AND FORM(S)/INSTRUCTIONS TO BE CHANGED
[ ] Health RBC Blanks [x] Property/Casualty RBC Blanks [ ] Life and Fraternal RBC Instructions
[ ] Health RBC Instructions [ ] Property/Casualty RBC Instructions [ ] Life and Fraternal RBC Blanks
[ ] OTHER ____________________________

DESCRIPTION OF CHANGE(S)
Eliminate PR038 Adjustment for Reinsurance Penalty for Affiliates Applicable to Schedule F.

REASON OR JUSTIFICATION FOR CHANGE **
As the computation of RBC charge for reinsurance recoverable has been moved to the Annual Statement Schedule F, Part 3 in 2018 reporting, the adjustment for Reinsurance Penalty for Affiliates Applicable to Schedule F in PR038 is no longer needed.

Additional Staff Comments:
8-4-19 The PCRBCWG exposed proposal 2019-12-P until 9-3-19.
11-8-19 This proposal has been adopted at the Joint Catastrophe Risk Subgroup and Property/Casualty Risk-Based Capital Working Group conference call on Nov. 8.

** This section must be completed on all forms.

Revised 2-2019
### Credit Risk for Receivables

#### Annual Statement Source: Adjustment For Reinsurance Penalty For Affiliates Applicable To Schedule F

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### Underwriting Risk - Reserves

#### Annual Statement Source: Medical Tabular Reserve Discount

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### Underwriting Risk - Premiums

#### Annual Statement Source: STMTINCOME (page 4, col.1 ln 4)

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Denotes items that must be manually entered on the filing software.
Capital Adequacy (E) Task Force

RBC Proposal Form

CONTACT PERSON: Eva Yeung
TELEPHONE: 816-783-8407
EMAIL ADDRESS: eyeung@naic.org
ON BEHALF OF: Catastrophe Risk (E) Subgroup
NAME: Tom Botsko
TITLE: Chair
AFFILIATION: Ohio Department of Insurance
ADDRESS: 50 West Town Street, Suite 300
Columbus, OH 43215

DATE: 11/8/2019

FOR NAIC USE ONLY
Agenda Item # 2019-14-CR
Year 2019

DISPOSITION
[ ] ADOPTED
[ ] REJECTED
[ ] DEFERRED TO
[ ] REFERRED TO OTHER NAIC GROUP
[ x ] EXPOSED 11/8/19
[ ] OTHER (SPECIFY)

IDENTIFICATION OF SOURCE AND FORM(S)/INSTRUCTIONS TO BE CHANGED
[ ] Health RBC Blanks
[ ] Property/Casualty RBC Blanks
[ ] Life RBC Instructions
[ ] Fraternal RBC Blanks
[ ] Health RBC Instructions
[ ] Property/Casualty RBC Instructions
[ x ] OTHER __Cat Event Lists__

DESCRIPTION OF CHANGE(S)

2019 U.S. and non-U.S. Catastrophe Event Lists

REASON OR JUSTIFICATION FOR CHANGE **

New events were determined based on the sources from Swiss Re and Aon Benfield.

Additional Staff Comments:

11/8/19 The Catastrophe Risk SG exposed the proposal for 14 days public comment period ending 11/24/19.

** This section must be completed on all forms. Revised 11-2013

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<th>Type of Event</th>
<th>Name</th>
<th>Date</th>
<th>Location</th>
<th>Overall losses when occurred</th>
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<td>Tropical Storm</td>
<td>Hermine</td>
<td>2010</td>
<td></td>
<td>$120,000,000</td>
</tr>
<tr>
<td>Hurricane</td>
<td>Earl</td>
<td>2010</td>
<td></td>
<td>$45,000,000</td>
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<tr>
<td>Hurricane</td>
<td>Irene</td>
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<td>10/03/17</td>
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<tr>
<td>2018</td>
<td>Super Typhoon</td>
<td>07/10/18</td>
<td>07/12/18</td>
<td>STY Maria, China, Taiwan, Guam and Japan, Fujian province, Yantze River Basin, Japan's Ryukyu Islands</td>
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<tr>
<td>2018</td>
<td>Tropical Storm</td>
<td>07/17/18</td>
<td>07/24/18</td>
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<td>2018</td>
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Source: Munich Re’s NAT CAT Service, Swiss Re Sigma and Aon Benfield
History of Risk-Based Capital by the NAIC

A. Background

1. The NAIC, through its committees and working groups, facilitated many projects of importance to the insurance regulators, industry and users of statutory financial information in the early 1990s. That was evidenced by the original mission statement and charges given to the NAIC Capital Adequacy (E) Task Force (CADTF) of the Financial Condition (E) Committee.

2. From the inception of insurance regulation in the middle 1800s, the limitation of insurance company insolvency risk has been a major goal of the regulatory process. The requirement of adequate capital has been a major tool in limiting insolvency costs throughout the history of insurance regulation. Initially, the states enacted statutes requiring a specified minimum amount of capital and surplus for an insurance company to enter the business or to remain in business.

3. Fixed minimum capital requirements were largely based on the judgement of the drafters of statutes and varied widely among the states. Those fixed minimum capital and surplus requirement have served to protect the public reasonably well for over a century. However, they fail to recognize variations in risk between broad categories of key elements of insurance, nor do they recognize difference in the amount of capital appropriate for the size of various insurers.

4. In 1992, the NAIC adopted the life risk-based capital (RBC) formula with an implementation date of year-end 1993. The formula was developed for specific regulatory needs. Four major categories were identified for the life formula: Asset Risk, Insurance Risk, Interest Rate Risk and All other Business Risk. The property and casualty and health formulas were implemented in 1994 and 1998, respectively. The focus of these formulas is Asset Risk, Underwriting Risk, Credit Risk and Business Risk (Health).

5. The total RBC needed by an insurer to avoid being taken into conservatorship is the Authorized Control Level RBC, which is 50 percent of the sum of the RBC for the categories, adjusted for covariance. The covariance adjustment is meant to take into account that problems in all risk categories are not likely to occur at the same time.

6. The mission of the Capital Adequacy (E) Task Force (CADTF) was to determine the minimum amount of capital an insurer should be required to hold to avoid triggering various specific regulatory actions. The risk-based capital (RBC) formula largely consists of a series of risk factors that are applied to selected assets, liabilities or other specific company financial data to establish the minimum capital threshold levels generally needed to bear the risk arising from that item.

37. To carry out the mission, the Capital Adequacy (E) Task Force (CADTF) was charged with carrying out the following initiatives:

- Evaluate emerging "risk" issues for referral to the risk-based capital (RBC) working groups/subgroups for certain issues involving more than one RBC formula. Monitor emerging and existing risks relative to their consistent or divergent treatment in the three RBC formulas.
Review and evaluate company submissions for the schedule and corresponding adjustment to total adjusted capital (TAC).

Monitor changes in accounting and reporting requirements resulting from the adoption and continuing maintenance of the revised NAIC Accounting Practices and Procedures Manual (AP&P Manual) and the NAIC Valuation Manual to ensure that model laws, publications, formulas, analysis tools, etc., supported by the Task Force continue to meet regulatory objectives.

The Risk-Based Capital RBC forecasting and instructions were developed and are now maintained in accordance with the mission of the Capital Adequacy (E) Task Force (CADTF) as a method of measuring the minimum threshold amount of capital appropriate for an insurance company to support its overall business operations in consideration of avoid capital specific regulatory requirements based on its size and risk profile.

B. Purpose of Risk-Based Capital

The purpose of risk-based capital RBC is to identify potentially weakly capitalized companies. This facilitates regulatory actions that in most cases ensure policyholders will receive the benefits promised without relying on a guaranty association or taxpayer funds. Consequently, the RBC formula calculates capital level trigger points that enable regulatory intervention in the operation of such companies.

determine the minimum capital (RBC levels) an insurer needs to operate its business and insurers should seek to maintain capital above the RBC levels.

RBC instructions, RBC reports and adjusted report(s) are intended solely for use by the commissioner/state in monitoring the solvency of insurers and the need for possible corrective action with respect to insurers and are considered confidential. All domestic insurers are required to file an RBC report unless exempt by the Commissioner. There are no state permitted practices to modify for the RBC formula and all insurers are required to abide by the RBC instructions.

Comparison of an insurer’s TAC to any RBC level is a regulatory tool which may indicate the need for possible corrective action with respect to the insurer and is not intended as a means to rank insurers generally. Therefore, except as otherwise required under the provisions of Risk-Based Capital (RBC) for Insurers Model Act (#312) or Risk-Based Capital (RBC) for Health Organizations Model Act (#315) (Model Laws), the making, publishing, disseminating, circulation or placing before the public, or causing, directly or indirectly to be made, published, disseminated, circulated or place before the public, in a newspaper, magazine or other publication, or in a form of a notice, or in any other way, an advertisement, announcement or statement containing an assertion, representation or statement with regard to the RBC levels of any insurer or of any component derived in the calculation by any insurer is prohibited.

C. History of Risk-Based Capital

From the inception of insurance regulation in the middle 1800s, the limitation of insurance company insolvency risk has been a major goal of the regulatory process. The requirement of adequate capital has been a major tool in limiting insolvency costs throughout the history of insurance regulation. Initially, the states enacted statutes requiring a specified minimum amount of capital and surplus for an insurance company to enter the business or to remain in business.

In 1992, the NAIC adopted the life risk-based capital formula with an implementation date of year-end 1993. The formula was developed for specific regulatory needs. Four major categories were identified for the life formula: Asset Risk, Insurance Risk, Interest Rate Risk and All other Business Risk. The property and casualty and health formulas were implemented in 1994 and 1998, respectively. The focus of these formulas is Asset Risk, Underwriting Risk, Credit Risk and Business Risk (Health).
10. The total risk-based capital needed by an insurer to avoid being taken into conservatorship is the Authorized Control Level Risk-Based Capital, which is 50 percent of the sum of the risk-based capital for the categories, adjusted for covariance. The covariance adjustment is meant to take into account that problems in all risk categories are not likely to occur at the same time.

BC. Objectives of Risk-Based Capital Reports

11. The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute, to provide an adequate margin of safety.

To support this role, the RBC reports identify potentially weakly capitalized companies in that each insurer must report situations where the actual Total Adjusted Capital is below a threshold amount for any of the several RBC levels. This is known as an RBC Event and reporting is mandatory. The state regulatory response is likely to be unique to each insurer as each insurer’s risk profile will have some differences from the average risk profile used to develop the RBC Formula factors and calculations.

There are several RBC Levels with different levels of anticipated additional regulatory oversight following the reporting of an RBC Event. Company Action Level (CAL) has the least amount of additional regulatory oversight as it envisions the company providing to its regulator a plan of action to increase capital or reduce risk or otherwise satisfy the regulator of the adequacy of its capital. The Regulatory Action Level (RAL) is the next higher level where the regulator is more directly involved in the development of the plan of action. The Authorized Control Level (ACL) anticipates an even higher amount of regulatory action in implementing the plan of action.

CD. Critical Concepts of Risk-Based Capital

12. Fixed minimum capital requirements have been largely based on the judgement of the drafters of statutes and varied widely among the states. Those fixed minimum capital and surplus requirement have served to protect the public reasonably well for over a century. Beginning in the 1960’s rapidly rising inflation brought rapidly rising interest rates.

13. Over the years, various financial models have been developed to try to measure the “right” amount of capital that an insurance company should hold. Risk-based capital seeks to modify the risk profile of all insurance companies to the point where they all have an equal probability of insolvency. No single formula or ratio can give a complete picture of a company’s operations, let alone the operation of an entire industry. However, a properly designed formula will help in the early identification of companies with inadequate capital levels and allow corrective action to begin sooner. This should ultimately lower the number of company failures and reduce the cost of any failures that may occur."

14. Because the NAIC formula develops a minimum threshold levels of capitalization rather than a target level, it is impractical to use the RBC formula to compare the minimum RBC level Ratio developed by one insurance company to the minimum level RBC Ratio developed by another. Comparisons of amounts that exceed the minimum-threshold standards do not provide a definitive assessment of their relative financial strength. For this reason, the Model Law prohibits insurance companies, their agents and others involved in the business of insurance using the company’s RBC results to compare competitors.

15. The principal focus of solvency measurement is determination of financial condition through analysis of the financial statements and risk-based capital. However, protection of the policyholders can

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1 Page 6- Report of the Industry Advisory Committee to the Life Risk-Based Capital (E) Working Group (11/17/91)
only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise’s ability to maintain itself as a going concern.

4616. The Capital Adequacy Task Force (CADTF) and its RBC Working Groups are charged with evaluating refinements to the existing NAIC risk-based capital formula and considering improvements and revisions to the various RBC blanks to 1) conform the RBC blanks to changes made in other areas of the NAIC to promote uniformity (when it is determined to be necessary); and 2) oversee the development of additional reporting formats within the existing RBC blanks as needs are identified.

4717. The Capital Adequacy (E) Task Force (CADTF) and its RBC Working groups will monitor and evaluate changes to the Annual Statement Blanks and Purposes and Procedure Manual of the NAIC Investment Analysis Office to determine if assets or specifically investments evaluated by the Security Valuation Office are relevant to the Risk-Based Capital formula in determining the minimum threshold capital and surplus for all insurance companies or whether reporting available to the regulator as a more appropriate means to addressing the risk. The Task Force will consider different methods of determining whether a particular risk should be added as a new risk to be studied and selected for a change to the applicable RBC formula, but due consideration will be given to the materiality of the risk to the industry as well as the very specific purpose of the RBC formulas to develop regulatory minimum threshold capital levels.
September 9, 2019          - sent electronically -

Commissioner Dave Altmaier, CATF Chair
and Ms. Jane Barr, NAIC Company Licensing and RBC Manager
National Association of Insurance Commissioners
701 Hall of the States
444 North Capitol Street, N.W.
Washington, D.C.  20001-1509

Re: AHIP’s Comments on the August 2019 exposure of a Risk-Based Capital (RBC) Preamble

Dear Commissioner Altmaier and Ms. Barr:

America’s Health Insurance Plans (AHIP) appreciates the opportunity to provide these comments on the RBC Preamble exposed at the August 2019 Summer National NAIC Meeting.

As AHIP noted in comments to the previous draft, we believe that a preamble is a positive addition to the RBC Framework and are supportive of adding one. We thank the Task Force for their receptiveness to comments on the previous draft. We believe the new version contains many improvements, however there are a few remaining areas where we believe small changes are needed in order to clarify the intent of RBC. These areas are as follows: (Note that we have also included a mark-up of the exposed preamble with the suggested wording changes):

Paragraph 3 - The last sentence seems to imply that RBC was/is needed because of rising interest rates and inflation. However, we think that was not the rationale. From the very beginning the concerns were with companies’ capital and variation in risk, as well as size of the company. Therefore, we recommend suggesting adding in place of the paragraph’s last sentence the following:

‘However, they fail to recognize variations in risk between broad categories of key elements of insurance, nor do they recognize differences in the amount of capital appropriate for the size of various insurers.’

Paragraph 6 – we suggest avoiding the use of the term “minimum capital” anywhere in the Preamble. The original purpose of RBC is not intended to set minimums, but rather specifies four threshold amounts or trigger points for varying types of regulatory oversight (see the comments on paragraph 12). Since the RBC formulas do not address all company issues (e.g. expansion into new areas, concentration of risk, etc.), the trigger points are for IDENTIFICATION and potential specific actions not minimums (like the state statutory requirements).
AHIP Comments on Risk-Based Capital (RBC) Preamble
August 26, 2019
Page 2

Paragraph 7 - The third bullet should also note the need to monitor the NAIC Valuation Manual as changes to reserves may well impact the risks (up or down) to the company's capital and surplus.

Paragraph 8 – We again suggest replacement of the word “minimum” with “threshold”. In addition, support for a company’s business operations goes well beyond RBC including future plans and potential needs to maintain certain business financial ratings. These are addressed by ORSA not by RBC. Hence, we have suggested alternate wording.

Paragraph 9 - The ending of this paragraph appears to say the all companies identified as "potentially weakly capitalized companies" are indeed weakly capitalized. That has been shown to not always be the case, as many companies have shown their regulators how the RBC components mis-identify them. We would recommend changing the ending to "in the operation of such companies."

In Paragraph 12 - We believe that the Preamble should not be silent on one of its most important elements - the use of multiple thresholds to identify issues and address them with less regulatory action. We recommend including the following additional paragraphs which outline the structure of the RBC Events approach.

“To support this role, the RBC Reports identify potentially weakly capitalized companies in that each insurer must report situations where the actual Total Adjusted Capital is below a threshold amount for any of the several RBC Levels. This is known as an RBC Event and reporting is mandatory. The state regulatory response is likely to be unique to each insurer as each insurer’s risk profile will have some differences from the average risk profile used to develop the RBC Formula factors and calculations.

There are several RBC Levels with different levels of anticipated additional regulatory oversight following the reporting of an RBC Event. Company Action Level (CAL) has the least amount of additional regulatory oversight as it envisions the company providing to its regulator a plan of action to increase capital or reduce risk or otherwise satisfy the regulator of the adequacy of its capital. The Regulatory Action Level (RAL) is the next higher level where the regulator is more directly involved in the development of the plan of action. The Authorized Control Level (ACL) anticipates an even higher amount of regulatory action in implementing the plan of action.”

In Paragraph 14 - We recommend the use of “RBC Ratio” and “threshold” rather than “minimum level” and “minimum” in this paragraph.

In Paragraph 17 - We recommend replacing “minimum” with “threshold” in this paragraph.
We thank you for your consideration of these comments and would be happy to address any questions the Task Force may have.

Sincerely,

Candy Gallaher, Senior Advisor – Policy and Government Affairs
America’s Health Insurance Plans
cgallaher@ahip.org

cc: William Weller, Omega Squared – Consultant to AHIP
    Ray Nelson, TriPlus Services – Consultant to AHIP
Risk-Based Capital
Preamble

History of Risk-Based Capital by the NAIC

A. Background

1. The NAIC, through its committees and working groups, facilitated many projects of importance to the insurance regulators, industry and users of statutory financial information in the early 1990s. That was evidenced by the original mission statement and charges given to the NAIC Capital Adequacy (E) Task Force (CADTF) of the Financial Condition (E) Committee.

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6. The mission of the Capital Adequacy (E) Task Force CADTF was to determine the minimum amount of capital an insurer should be required to hold to avoid triggering various specific regulatory actions. The risk-based capital (RBC) formula largely consists of a series of risk factors that are applied to selected assets, liabilities or other specific company financial data to establish the minimum capital threshold levels generally needed to bear the risk arising from that item.

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- Review and evaluate company submissions for the schedule and corresponding adjustment to total adjusted capital (TAC).
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- Monitor changes in accounting and reporting requirements resulting from the adoption and continuing maintenance of the revised NAIC Accounting Practices and Procedures Manual (AP&P Manual) and the NAIC Valuation Manual to ensure that model laws, publications, formulas, analysis tools, etc., supported by the Task Force continue to meet regulatory objectives.

48. The Risk-based Capital RBC forecasting and instructions were developed and are now maintained in accordance with the mission of the Capital Adequacy (E) Task Force CADTF as a method of measuring the minimum threshold amount of capital appropriate for an insurance company to avoid capital specific regulatory requirements based on support its overall business operations in consideration of its size and risk profile.

B. Purpose of Risk-Based Capital

59. The purpose of risk-based capital RBC is to identify potentially weakly capitalized companies. This facilitates regulatory actions that in most cases ensure policyholders will receive the benefits promised without relying on a guaranty association or taxpayer funds. Consequently, the RBC formula calculates capital level trigger points that enable regulatory intervention in the operation of such weakly capitalized companies, determine the minimum capital (RBC levels) an insurer needs to operate its business and insurers should seek to maintain capital above the RBC levels.

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C. History of Risk-Based Capital

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Preamble

account that problems in all risk categories are not likely to occur at the same time.
BC. Objectives of Risk-Based Capital Reports

1112. The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute, to provide an adequate margin of safety.

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14. Because the NAIC formula develops a minimum threshold levels of capitalization rather than a target level, it is impractical to use the RBC formula to compare the RBC Ration minimum RBC level developed by one insurance company to the RBC Ration minimum level developed by another. Comparisons of amounts that exceed the threshold minimum standards do not provide a definitive assessment of their relative financial strength. For this reason, the Model Law prohibits insurance companies, their agents and others involved in the business of insurance using the company’s RBC results to compare competitors.

15. The principal focus of solvency measurement is determination of financial condition through analysis of the financial statements and risk-based capital. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise’s ability to maintain itself as a going concern.

16. The Capital Adequacy Task Force (CADTF) and its RBC Working Groups are charged with evaluating refinements to the existing NAIC risk-based capital formula and considering improvements and revisions to the various RBC blanks to 1) conform the RBC blanks to changes made in other areas of the NAIC to promote uniformity (when it is determined to be necessary); and 2) oversee the development
Preamble

additional reporting formats within the existing RBC blanks as needs are identified.

1717. The Capital Adequacy (E) Task Force CADTF and its RBC Working groups will monitor and evaluate changes to the Annual Statement Blanks and Purposes and Procedure Manual of the NAIC Investment Analysis Office to determine if assets or specifically investments evaluated by the Security Valuation Office are relevant to the Risk-Based Capital formula in determining the threshold minimum capital and surplus for all insurance companies or whether reporting available to the regulator as a more appropriate means to addressing the risk. The Task Force will consider different methods of determining whether a particular risk should be added as a new risk to be studied and selected for a change to the applicable RBC formula, but due consideration will be given to the materiality of the risk to the industry as well as the very specific purpose of the RBC formulas to develop regulatory threshold minimum capital levels.

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1 Page 6- Report of the Industry Advisory Committee to the Life Risk-Based Capital (E) Working Group (11/17/91)

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To: Commissioner David Altmaier, Chair of the Capital Adequacy (E) Task Force
    Kevin Fry, Chair of the Valuation of Securities (E) Task Force
    Jake Garn, Chair of the Blanks (E) Working Group
From: Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group
Date: August 13, 2018
Re: NAIC Designations for Schedule D, Part 2 – Section 2 – Common Stocks

The purpose of this referral is to communicate the Statutory Accounting Principles (E) Working Group’s support for the consideration of reporting revisions to permit NAIC designations for SEC registered funds (mutual funds, closed end funds and unit investment trusts), in scope of SSAP No. 30—Unaffiliated Common Stock (reported on Schedule D, Part 2 – Section 2 – Common Stock (D-2-2)), if determined appropriate based on the underlying holdings of the fund. (It is presumed that such NAIC designations would only be permitted for SEC registered funds that are comprised of bond or qualifying preferred stock investments.)

This referral was developed in response to requests to move equity investments that have underlying bond investments from the scope of SSAP No. 30 to the scope of SSAP No. 26R—Bonds in order to obtain more appropriate risk-based capital (RBC) charges. In reviewing the request, the Statutory Accounting Principles (E) Working Group has concluded against moving these equity investments to SSAP No. 26R for the following reasons:

- SEC registered funds in scope of SSAP No. 30 are not bonds, and do not represent a creditor relationship whereby there is a fixed schedule for one or more future payments.

- The long-term bond schedule (Schedule D-1) is not conducive to the reporting of funds, and questions often arise on the proper completion of Schedule D-1 for the limited equity investments already captured in scope of SSAP No. 26R. (For example, several columns on Schedule D-1 are not applicable for funds including interest rate, par value, maturity date, etc.)

- Existing guidance that allows SVO-Identified ETFs to be reported in scope of SSAP No. 26R, on Schedule D-1, has historically resulted with inconsistent reporting for similar investments. Companies may not identify that they have investments permitted for reporting on Schedule D-1 and continue to report these investments on Schedule D-2-2, or companies may infer the limited SSAP No. 26R provisions to additional investments that do not qualify for Schedule D-1 reporting.

- The desire for equity investments to be within scope of SSAP No. 26R is driven by RBC charges and not the investment structure or the measurement method for the investment.

Although the Statutory Accounting Principles (E) Working Group supports the consideration of revisions to permit NAIC designations on Schedule D-2-2, the Statutory Accounting Principles (E) Working Group defers to each of the identified groups in determining whether it is appropriate and feasible to incorporate these revisions. The ability to report NAIC designations on Schedule D-2-2 would require revisions that would include, at a minimum, the following assessments:

2. Valuation of Securities (E) Task Force – Consider and establish a methodology for reviewing equity investments with underlying bond investments and in determining the appropriate NAIC designation.
3. Capital Adequacy (E) Task Force – Consider and determine the extent, if any, the reported NAIC designation for the SEC registered investment should be factored into the RBC calculation.

Although the Statutory Accounting Principles (E) Working Group has previously communicated that they do not plan to entertain future requests to reclassify investments to be in scope of a different SSAP when the key driver is an RBC charge, this issue was raised as part of the Statutory Accounting Principles (E) Working Group’s current project to review SSAP No. 30 under the investment classification project. Going forward, if future requests are received, the Working Group intends to direct inquirers to the appropriate NAIC group for RBC assessment.

A referral response is not expected, as there will be no statutory accounting impact regardless of the ultimate decision. As noted, the Statutory Accounting Principles (E) Working Group has previously concluded against moving these equity investments from the scope of SSAP No. 30 to SSAP No. 26R.

Please contact NAIC staff of the Statutory Accounting Principles (E) Working Group with any questions.

Cc: Julie Gann, Robin Marcotte, Fatima Sediqzad, Jake Stultz, Charles A. Therriault, Robert Carcano, Mary Caswell, Calvin Ferguson, Jane Barr, Lou Felice
To: Commissioner Altmaier, Chair of the Capital Adequacy (E) Task Force  
    Kevin Fry, Chair of the Valuation of Securities (E) Task Force  
From: Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group  
Date: November 27, 2018  
Re: Foreign Mutual Funds

During the Fall National Meeting, the Statutory Accounting Principles (E) Working Group exposed agenda item 2018-34 proposing to explicitly include registered foreign mutual funds in scope of SSAP No. 30R—Unaffiliated Common Stock. (The revisions explicitly exclude other foreign funds from the scope of the SSAP.) This agenda item was developed pursuant to an industry request in response to substantive revisions to SSAP No. 30R. Although industry supported adopting the substantive revisions, it was identified that foreign mutual funds have previously been captured in scope of SSAP No. 30 (under the generic scope reference of “mutual funds”). The industry comments identified that the substantive revisions to include SEC-registered open-end funds (mutual funds), closed-end funds and unit-investment trusts in scope of SSAP No. 30R, perhaps inadvertently excluded foreign mutual funds. Consistent with industry’s request, the substantive revisions to SSAP No. 30R were adopted during the Fall National Meeting (under agenda item 2017-32), and the Working Group exposed proposed revisions to consider foreign mutual funds in scope.

Although there is a general assessment that foreign mutual funds should be treated similarly to foreign common stock, (which are in scope of SSAP No. 30R), the Statutory Accounting Principles (E) Working Group directed referrals to the Valuation of Securities (E) Task Force and the Capital Adequacy (E) Task Force to inquire on the exposure and solicit input. Specifically, comments were requested on the following questions:

1) Should only certain jurisdictions be permitted to have their registered mutual funds included as common stock? (For example, UK, Hong Kong, Canadian, etc.)

2) Should Canadian registered mutual funds continue to be considered “domestic securities” in accordance with the current annual statement instructions? (Under current annual statement instructions, Canadian securities are considered domestic securities.) Would the classification of Canadian mutual funds as “domestic” securities result with an inappropriate assessment that they represent U.S. SEC registered funds? If reported as domestic securities, should a new code or other reporting mechanism be established to identify Canadian mutual funds on Schedule D-2-2?

3) Should all foreign mutual funds be captured in the Supplemental Investment Risk Interrogatory as foreign investments? For example, question 4.01 of the Interrogatory asks whether foreign investments are less than 2.5% of total admitted assets. If an entity has more than 2.5% in foreign investments, then additional information on the foreign securities is required. The ultimate question is whether an investment in a registered foreign mutual fund should be captured in determining whether the foreign threshold percentage is met. If included in the total, then the issue is whether the subsequent foreign investment Integratory questions should be answered in accordance with the country that registered the fund, without a look-through to the underlying origin of the investments held in the foreign mutual fund. (The subsequent questions ask for the foreign investment exposure by the NAIC sovereign designation.) The risk is that allocating a foreign mutual fund to the registration country may not provide accurate information on the actual exposure of the investments within the fund, particularly if the registered foreign fund is made up of investments from other countries.
For example, SEC-registered mutual funds could be “global funds,” meaning they invest primarily in foreign companies with investments also in U.S. companies, or “international funds,” meaning that they invest in companies outside of the United States. Other SEC-Registered funds include “regional or country funds,” which invest primarily in a particular region or country, or “international index funds,” which seek to track the results of a particular foreign market or international index.

4) Should there be clarification that only U.S. SEC registered mutual funds are permitted to be identified as “diversified” and excluded from the Asset Concentration Factor section of the risk-based capital filing, or should all funds that are diversified in accordance with the SEC Investment Company Act of 1940 be excluded from this factor?

- The current interrogatory asks whether there are diversified mutual funds reported on Schedule D-2-2 (diversified according to the SEC Investment Company Act of 1940, Section 5(b)(1)). Technically, this current question does not restrict the reporting to SEC registered mutual funds. As such, it is uncertain whether foreign mutual funds that meet the diversification requirements of the 1940 Act are permitted to be reported in this Interrogatory.

- It has been communicated that certain Exchange Traded Funds (ETFs), although not registered as mutual funds, are diversified in accordance with the Investment Company Act of 1940, Section 5(b)(1). The question is whether these funds should be captured in the general interrogatory for exclusion from the asset concentration factor for RBC purposes. (If these funds should be captured in the GI, then a subsequent revisions will likely be proposed to clarify what is permitted to be reported.)

Thank you for your attention to this referral. If possible, a response would be preferred by Feb 15, 2019 to correspond with the Statutory Accounting Principles (E) Working Group exposure deadline. Consideration of comments received is planned to occur during the 2019 Spring National Meeting.

Please contact NAIC staff of the Statutory Accounting Principles (E) Working Group with any questions.

Cc: Charles A. Therriault, Robert Carcano, Jane Barr, Julie Gann, Robin Marcotte, Jake Stultz and Fatima Sediqzad

Attachment: Agenda Item 2018-34

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MEMORANDUM

TO: David Altmaier, Chair, Capital Adequacy (E) Task Force
FROM: Kevin Fry, Chair, Valuation of Securities (E) Task Force
CC: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Robert Carcano, NAIC Consultant

RE: Referral to the Capital Adequacy (E) Task Force – Request for Assignment of Risk-Based Capital (RBC) Charges for Funds That Predominantly Hold Bonds

DATE: May 10, 2019

1. **Introduction** – The Valuation of Securities (E) Task Force requests that the Capital Adequacy (E) Task Force consider formally integrating the comprehensive instructions for mutual funds recently adopted for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) into the NAIC RBC framework. The mutual funds for which integration is sought: 1) are issued by investment companies registered with and regulated by the U.S. Securities and Exchange Commission (SEC); 2) whose offering is registered with the SEC; 3) whose published investment objective is to invest solely in bonds or solely in preferred stock; 4) are all within scope of the *Accounting Practices and Procedures Manual* (AP&P Manual); 5) cannot be purchased and reported as filing exempt (FE) on the basis of a nationally recognized statistical rating organization (NRSRO) credit rating; and 6) are subject to a pre-purchase review and identification procedure performed by the SVO.¹

2. **Background** – The primary financial solvency tool of the Valuation of Securities (E) Task Force is a number of related analytical methodologies for the quantification of non-payment risk. These tools have often been used to identify and facilitate investments that provide insurers a needed return at a lower non-payment risk. The Task Force first recognized that bond mutual funds could be structured to perform much better than equity in 1991. Over the next (almost) 30 years, the Task Force developed specific narrow exceptions where the SVO could analyze the cash flow from these specific bond fund types and determine if there would be lower non-payment risk than that associated with shares of common stock. Two Task Force exceptions adopted prior to the adoption of the AP&P Manual and one adopted afterward sought to characterize shares of such funds as being “bond-like” and were accommodated by including them as in scope of *Statement of Statutory Accounting Principles SSAP No. 26R—Bonds*. Over time, it became increasingly clear that the reporting of non-bond instruments in a framework developed for bonds produces reporting problems that can be avoided if it is recognized that the intent is to provide regulatory treatment consistent with credit risk.

¹ The Valuation of Securities (E) Task Force’s procedure permits the sponsor of a fund or an insurer to request an SVO assessment of a fund to determine if it meets requirements imposed by the Task Force for more appropriate treatment and if the fund is in scope of the AP&P Manual. If the fund is eligible, the SVO adds the name of the fund to the relevant list with a preliminary NAIC designation. The various lists are published. If an insurance company buys a fund on a list, it files that security with the SVO for an official NAIC designation. The SVO assigns an official NAIC designation and enters the security and designation into NAIC systems only after it confirms that nothing has changed since its initial assessment.
Since 2013, the SVO has expressed concern that it was frequently presented with bond mutual funds it could not designate, solely because they were not issued by an investment company operating as open-end management companies (the only company in scope of SSAP No. 30R—Unaffiliated Common Stock). Significant staff resources were being expended by the SVO and the NAIC Financial Regulatory Services (FRS) Division to manage the situation. In 2017, the SVO and the FRS Division asked the Task Force for permission to draft a clarifying amendment to the P&P Manual, explaining that mutual funds should not be filed with the SVO unless they strictly comply with the rules in the P&P Manual and AP&P Manual. The SVO staff also cautioned that the lack of a comprehensive approach to this asset class posed a significant risk to state insurance regulation because credit rating organizations were assigning credit ratings to funds that insurers could use to report fund shares as bonds under the FE rule. Therefore, the SVO urged the Task Force to consider modernizing the rules for bond mutual funds. On Sept. 27, 2017, the Task Force directed NAIC staff to develop a comprehensive proposal to ensure consistent treatment for investments in funds that only hold bond portfolios across all the schedules. About the same time, the Statutory Accounting Principles (E) Working Group announced a project to expand the scope of SSAP No. 30R to bring in scope funds issued by closed-end management companies and unit investment trusts. Subsequently, and in partial response to the Task Force’s fund initiative, the Working Group and the Blanks (E) Working Group expressed support for adding a column to Schedule D, Part 2, Section 2 that would permit funds designated by the SVO (and only funds designated by the SVO) to be reported on that schedule, but with an NAIC designation that could, in turn, align with an RBC factor to be determined by the Capital Adequacy (E) Task Force.

3. Referral – The Valuation of Securities (E) Task Force received and considered 18 comment letters: 15 in support and three opposed. The letters in support emphasized that the continued designation of bond funds assists financial solvency objectives of all insurers, but it is especially important for small and medium-size insurers, who face significant challenges and incur significant costs when purchasing individual bonds.

One letter opposed to the instructions argued that C-1 for bonds is based on default which bonds held by a fund will never experience because fund managers have an incentive to sell any bond that is downgraded. (The commenter’s observation that bonds in a portfolio would be sold before the default would seem to the SVO staff to be a positive attribute and in alignment with financial solvency objectives.) The point of this commenter was that funds are more likely to experience losses attributable to credit deterioration than to default, with the conclusion being that funds are not a proper subject for RBC. A second comment letter agreed that the current C-1 treatment for funds could be refined, but expressed concern that adopting a credit rating methodology could trigger materially lower, and potentially inadequate, life RBC charges without proper consideration of the risks to statutory surplus. Both of these arguments interpose highly technical arguments that not only ignore that the NAIC, through the Task Force and the SVO, have been assessing the cash flow and risk characteristics of bond funds for almost 30 years, but also ignores that the Task Force intentionally made a policy decision to use NAIC designations as a proxy to represent those risk characteristics of bond funds. They also ignore that while RBC factors are derived from an assessment of corporate bond defaults, they are applied to municipal and structured securities, as well as many other instruments that are not corporate bonds and do not have the cash flow or default risk characteristics of corporate bonds. The proposed continued use of the RBC framework for bond mutual funds is a similar recognition of the need to use available tools to provide workable (if imperfect) solutions to real-world challenges. Concerns expressed in a third comment letter were factually clarified in a number of public discussions, and the factual clarifications are summarized below for your convenience.2

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2 The comprehensive instructions do not expand bond treatment or permit funds not in scope of the SSAPs. The proposal expands the existing framework to funds issued by investment companies organized as closed-end management companies and unit investments trusts. This was done to recognize that such U.S. Securities and Exchange Commission (SEC)-regulated funds may be identical to those issued by open-end management companies and to align the SVO framework with the AP&P Manual SSAPs, which bring these entities in scope of SSAP No. 30R as common stock reported on Schedule D, Part 2, Section 2. Investments in SVO-verified money market funds would still be reported as cash equivalents under SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments without a designation. SVO-identified bond exchange-traded funds (ETFs) would still be reported as bonds under SSAP No. 26R with an SVO-assigned NAIC designation, as has been the case since 2006. Investments in ETFs not captured on an SVO listing would continue to be reported as common stock under SSAP No. 30R without an NAIC designation. Private funds would still be reported as joint ventures under SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies captured on
The Task Force requests that the Capital Adequacy (E) Task Force consider attributing the bond RBC factors to all bond and preferred stock funds. This approach is easy to implement and consistent with past NAIC practice; including both the role of the Valuation of Securities (E) Task Force in identifying the risks in securities and the practical approach expressed in the administration of the RBC framework, which is based on default characteristics of corporate bonds but applied to many other instruments with risk and default characteristics unlike those of corporate bonds. The recommended approach is sought for an NAIC activity successfully conducted for almost 30 years and for an asset class that is heavily regulated, has been successful for 85 years in many differing economic environments and provides potentially significant efficiencies to insurers.

Schedule BA, and annual financial statement instructions will continue to permit life and fraternal companies to report an NAIC designation for fixed-income investments.
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MEMORANDUM

To: David Altmaier, Chair, Capital Adequacy (E) Task Force

From: Kevin Fry, Chair, Valuation of Securities (E) Task Force

Cc: Robert Carcano, Senior Counsel, NAIC Investment Analysis Office
    Julie Gann, Senior Manager, NAIC Financial Regulatory Services Division

Date: September 21, 2018

Re: Referral to the Capital Adequacy Task Force - Comprehensive Fund Proposal

1. Introduction – In mid-2017, the SVO and FRS asked for an instruction to draft guidance for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to clarify eligibility of fund investments for assignment of NAIC Designations. The SVO explained that many funds are excluded from designation eligibility but are structurally identical to those permitted under the P&P Manual and the Accounting Practices and Procedures Manual (AP&PM). On Sept. 27, 2017, the Valuation of Securities (E) Task Force (VOS TF) directed NAIC staff to develop a comprehensive proposal to ensure consistent treatment for investments that involved funds that invest in bond portfolios.

2. Background – The VOS TF has permitted more appropriate treatment to funds that invest in bonds and possess other defined characteristics since 1991, as summarized below:

- **1991** – Money market mutual funds that hold short-term U.S. Treasuries - exempted from reserve.¹
- **1992** – Funds holding U.S. direct and full faith and credit obligations - exempted from reserving
- **1992** – Funds holding high quality corporate bonds & U.S. Government obligations - reserve as NAIC 1 bonds².
- **1995** – Short-term bond funds - holding high quality corporate & U.S./GSO obligations - Schedule D; market value & reserved as bonds for AVR and RBC³.
- **2003** – Exchange Traded Funds that held bonds – report as bonds.⁴
- **2005** – BA assets with fixed income characteristics can be assigned NAIC Designations.⁵
- **2017** – SVO authorized to assign NAIC Designations to private Schedule BA funds, joint ventures or partnership interests if underlying investments are fixed-income like to align with Annual Reporting Instruction.⁶

Significant efforts have also been made to align guidance in the P&P Manual and the AP&PM for this investment, as summarized below:

- Investments in money market mutual funds are reported as cash equivalents under SSAP No. 2R without an NAIC Designation.
- SVO-Identified Bond ETFs are reported as bonds under SSAP No. 26R with an NAIC designation as assigned by the SVO.
- SVO-Identified Preferred Stock ETFs are reported as preferred stock under SSAP No. 32 with an NAIC designation as assigned by the SVO.

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¹ NAIC Proceedings 1991 Vol I-A pages 505, 520, 531
² NAIC Proceedings, 1993 Vol 1B, page 770; and Nov. 9, 1992 minutes of the IMR AVR Study Group
³ NAIC Proceedings, 1995 2Q, pages 419, 437, 467 – 472
⁴ NAIC Proceedings 2003 1Q, page 730; 2003 2Q, pages 810 - 813; 4Q page, 1859
⁶ See the minutes of the Valuation of Securities (E) Task Force conference call held November 13, 2017
• Investments in ETFs (not captured on an SVO listing) are reported as common stock under SSAP No. 30 without an NAIC designation.
• SVO-Identified Bond Mutual Funds are reported under SSAP No. 26R with an NAIC 1 designation.
• All other mutual funds (regardless of what they hold, if they are not on an SVO listing) are reported under SSAP No. 30 without an NAIC designation.
• Under a current initiative related to a review of SSAP No. 30 the SAP WG is considering whether all investments in a registered investment company should be captured in scope of SSAP No. 30. (This would expand the current reference to “mutual funds” to also include closed-end funds and unit investment trusts within scope of SSAP No. 30.) (A related initiative is discussed in this footnote.)

Guidance for non-SEC registered funds is not explicit within the AP&PM, but industry has reported such investments as joint ventures pursuant to SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. These investments are captured on Schedule BA, with an NAIC designation permissible for fixed-income investments held by life and fraternal companies.

The Comprehensive Fund Proposal would unify guidance for all fund investments in a new section in the P&P Manual. All existing procedures for fund investments developed by the VOS TF since 1991 would be retained. The proposal would expand existing policy to funds issued by an investment company that is a closed end fund or a unit investment trust type registered with and regulated by the U.S. SEC. This tracks the SAPWG’s proposed expansion of SSAP No. 30 discussed above and the blanks initiative discussed in footnote 7. The policy that fund investments are not eligible for filing exemption would be extended to the new fund procedure and to private (Schedule BA) funds. Analytical definitions, criteria, methodology and instructions are modernized. Greater detail on analytics provides enhanced transparency to insurers.

### 3. Referral

The VOS TF refers to the CAD TF a recommendation that it conduct a comprehensive review of all funds (as described above) that can be assigned NAIC Designations by the SVO and consider how those NAIC Designations should be included into the RBC calculation; specifically, for the CAD TF to consider what RBC changes they would like to make once NAIC Designations are added to Schedule D-2-2. Currently, bond ETFs and private funds receive different RBC treatment than other similarly structured funds. Equalizing the RBC treatment for assets with similar credit risk, represented by the SVO assigned NAIC Designation, when joined with the proposed changes in the P&P Manual and those made in the AP&PM over the last several years would provide a consistent and uniform NAIC process consistent with regulatory needs for an asset that has experienced significant evolution since 1991.

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7 In furtherance of its consideration of SSAP No. 30, on August 15, 2018, the SAP WG sent a referral to the Capital Adequacy (E) Task Force, Valuation of Securities (E) Task Force and the Blanks (E) Working Group noting support for the consideration of revisions to permit NAIC designations on Schedule D-2-2—Common Stock. As detailed within that referral, the SAPWG defers to each of the noted groups in determining whether it is appropriate and feasible to incorporate the revisions.

8 In each of the above assignments, if the SVO confirms that criteria and characteristics specified by the VOS TF are met, it places the name of the fund on a published List. An insurer can purchase any fund on the List and then files the fund shares with the SVO for an NAIC Designation. If the criteria and characteristics have not changed in the interim, the SVO assigns an NAIC Designation to the fund and annually reviews the Designation.
June 25, 2018

Mr. Kevin Fry  
Chair, Valuation of Securities (E) Task Force  
National Association of Insurance Commissioners  

Re: VOSTF Proposal to Add Comprehensive Instructions for Fund Investments to the P&P Manual  

Mr. Fry,  

The C1 Work Group (C1WG) of the American Academy of Actuaries,¹ appreciates the opportunity to comment on the National Association of Insurance Commissioners (NAIC) Valuation of Securities Task Force’s (VOSTF) Proposal to Add Comprehensive Instructions for Fund Investments to the Purposes and Procedures (P&P) Manual (Proposal). The stated purpose of this Proposal is “to prepare a comprehensive proposal to ensure all funds that hold underlying fixed income assets as portfolio assets are treated consistently irrespective of the NAIC Schedule on which the asset is reported.” If adopted, this Proposal could have unintended effects on the calculation of a life insurer’s Risk-Based Capital (RBC) by significantly decreasing the capital requirements for certain bond funds. Because of the potential unintended effects on RBC, we have concerns with this Proposal. We suggest that the issue of capital requirements for Fund Investments be referred to the NAIC’s Capital Adequacy Task Force (CADTF), and that this VOSTF Proposal be deferred pending the outcome of the CADTF analysis.

Our reservations about the Proposal are twofold: (1) We have a procedural concern that any proposal that fundamentally impacts capital should be considered by CADTF, and (2) we are concerned that the Proposal may reduce the capital requirements for fund investments below regulators’ stated statistical level.

The term “consistent treatment” is not explicitly defined in the Proposal, yet the result of the Proposal is to rate certain funds as having identical risks to a portfolio of individual bonds. As described in the Proposal, the SVO staff has proposed the use of a speculative risk analysis to rate bond funds. The result of this speculative risk analysis is the assignment of an NAIC bond rating to the fund. In turn, this bond rating would be used in the calculation of Life Risk-based Capital (LRBC) charges. Instead of the current base 30% LRBC C-1 factor for mutual funds in general (subsequently raised to 45% or lowered to 22.5% through the Beta Adjustment), these

¹ The American Academy of Actuaries is a 19,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.
rated funds would receive a C-1 factor based on the same scale as corporate bonds, where the lowest C1 factor is 0.4%.

If this Proposal is adopted by VOSTF, it is possible that the C-1 RBC factor for a fund would be reduced from 45% to 0.4%. We believe that a proposal such as this should be reviewed by CADTF prior to adoption.

We note that the CADTF has not considered the possibility of using the C-1 bond factors for any purpose other than for assessing a capital requirement for credit risk for individual bonds. Further, funds include risks other than credit risks. If VOSTF adopts this Proposal, LRBC calculations will be affected until or unless CADTF and other NAIC groups take action to exempt these rated funds from corporate bond treatment. Given the potential for a material reduction in the capital charges for rated funds, VOSTF should consider the impact of adoption of this proposal in advance of the CADTF’s review of the risks and appropriate LRBC charges.

The C1WG has been working with the NAIC’s Investment RBC Working Group to update the LRBC C-1 bond charges. We have concerns where the Proposal states that “If you look through the fund to the financial dynamic of its portfolio, the portfolio cash flow to the insurer should have the same predictability, periodicity and credit quality as when a non-fund entity directly holds the individual bonds of that issuer in its portfolio.”

Essentially, funds do not contain the same characteristics and risks as a portfolio of bonds because funds do not promise repayments of principal, and thus cannot be evaluated by “credit risk” analysis. For a fund (a bond exchange-traded fund (ETF) or a bond fund), risk to statutory surplus is measured by price volatility if the fund is carried at fair value. In contrast, for an individual bond, the risk to statutory surplus is measured by the change in value due to credit risk (i.e., the risk that the creditor will default on its obligation to pay back the borrowed funds according to the specified terms) because bonds are carried at amortized cost. Further analysis of the risks of the different types of bond funds will help illustrate how funds affect statutory surplus.

Devising a process to modify the LRBC treatment of these funds by looking through to their holdings requires further analysis to preclude the proposed change from unintentionally undermining the LRBC calculation, in particular the intended statistical coverage level of the C1 bond factors. We note the following differences between funds and individual bonds should be considered in the analysis of risks and LRBC charges:

a. The investor has no creditor relationship with a fund;
b. A fund does not produce a contractually guaranteed stream of cash flows from coupon income and maturities; a five-year ETF will always be a five-year ETF whereas a five-year corporate bond can only 1) prepay, 2) default on its promise to pay, or 3) mature;
c. The investment objective for managing a fund containing slices of bonds is different from the investment objective for managing a portfolio of bonds;
d. A fund is not homogeneous and its composition can vary, including assets other than bonds.
e. Using a rating process that weights the credit rating of the underlying bonds results in a weighted rating that is based on the average credit risk, but C-1 bond factors are designed to capture the full quality range of credit risk in a portfolio which can perform differently than an average rating;

f. LRBC C-1 bond charges are based on statutory loss, defined relative to the statutory carrying value of amortized cost. The charges do not consider current fair value effects on surplus; and

g. LRBC C-1 bond charges are based on the observed credit experience for corporate bonds. The default and recovery rates have been derived from published studies. There is no basis in research for applying these bond factors to a fund, and, if done, the resulting capital charge may not be appropriate.

The C1WG understands the need to reconsider the RBC factors for certain funds. While it is possible that the current C1 treatment for funds could be refined, it would be premature to adopt a credit rating methodology that could trigger materially lower, and potentially inadequate, LRBC charges without proper analysis and consideration of the issues. We are concerned that this proposed change in reporting and rating funds could present an indirect way of reducing capital requirements without proper and robust discussion of the risks to statutory surplus. Adopting this rating methodology at this time would undermine the LRBC calculation and the established procedures for reviewing and refining the LRBC formula.

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We welcome the opportunity to discuss our concerns with the VOSTF. Please contact American Academy of Actuaries Senior Life Fellow Nancy Bennett (bennett@actuary.org) with any questions.

Sincerely,

Nancy Bennett, MAAA, FSA, CERA
Co-Chairperson, C1 Work Group
American Academy of Actuaries

Jerry Holman, MAAA, FSA, CFA
Co-Chairperson, C1 Work Group
American Academy of Actuaries

CC: Commissioner David Altmaier
Chair, Capital Adequacy (E) Task Force
National Association of Insurance Commissioners

Jane Barr
Company Licensing and RBC Manager
National Association of Insurance Commissioners
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November 8, 2019

Re: NAIC Capital Adequacy (E) Task Force (“the Task Force”) exposure of Referral to the Capital Adequacy (E) Task Force – Request for Assignment of Risk-Based Capital (RBC) Charges for Funds That Predominantly Hold Bonds (“the Exposure”)

Dear Commissioner Altmaier and Commissioner Kiser:

The American Council of Life Insurers (ACLI)¹ and the North American Securities Valuation Association (NASVA)² (“the undersigned”) appreciate the opportunity to comment on the Exposure, which has a November 8, 2019 comment period deadline, as exposed by the Task Force on October 8, 2019.

The undersigned are supportive of the request that the Task Force consider formally integrating the comprehensive instructions for fund investments recently adopted for the Purposes and Procedures Manual of the NAIC Investment Analysis Office (“P&P Manual”) into the NAIC RBC framework and consider attributing bond RBC factors to all bond and preferred stock funds filed with and assigned an NAIC designation by the NAIC Securities Valuation Office (“SVO”).

Funds predominantly holding bonds or preferred stocks offer insurance companies access to diversification and solid risk adjusted returns, as well as liquidity and cash flows streams well suited to our asset/liability matching (“ALM”) needs. The operational and cost efficiencies offered by fund structures in comparison to purchases of individual bonds is especially relevant for small and medium sized insurers. However, the severe RBC charges assessed against a broad swath of bond and preferred stock focused fund structures currently available, without consideration of or adjustment for the actual

¹ The American Council of Life Insurers (ACLI) advocates on behalf of 280 member companies dedicated to providing products and services that promote consumers’ financial and retirement security. 90 million American families depend on our members for life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, dental and vision and other supplemental benefits. ACLI represents member companies in state, federal and international forums for public policy that supports the industry marketplace and the families that rely on life insurers’ products for peace of mind. ACLI members represent 95 percent of industry assets in the United States. Learn more at www.acli.com.

² The North American Securities Valuation Association (NASVA) is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC’s ISIS electronic security filing system, and commenting on year-end processes.
risk profile of a respective fund vehicle’s underlying asset portfolio, serve as a regulatory impediment artificially limiting insurance industry access to an economically attractive and operationally efficient component of a balanced and prudently managed insurance company investment portfolio.

The P&P Manual outlines a rational and seasoned methodology the SVO has used for decades in assessing the risks inherent to such investments through the lens of the regulatory objective, and provides an efficient means of communicating those risks in a manner which is both familiar and meaningful (i.e., via NAIC Designations). The undersigned view this methodology as a sound conceptual foundation for building out the integration of more proximately risk-based capital charges for fund structures investing predominantly in bonds or preferred stocks, and we look forward to collaborating with the Task Force as this initiative continues to evolve.

Please do not hesitate to contact us should you have any questions. Thank you.

Sincerely,

[Signature]

Tracey Lindsey
Senior Director, Accounting Policy
American Council of Life Insurers

[Signature]

Mike Monahan
President
North American Securities Valuation Association

cc: Ms. Jane Barr, NAIC Company Licensing and RBC Manager
13 February, 2019

Commissioner David Altmaier  
Chair, NAIC Capital Adequacy (E) Task Force

Acting Director Kevin Fry  
Chair, NAIC Valuation of Securities (E) Task Force

National Association of Insurance Commissioners  
2301 McGee Street, Suite 800  
Kansas City, MO 64108

Via email

Re: “Proposal to Add Comprehensive Instructions for Fund Investments to the P&P Manual,” January 31, 2018

Dear Commissioner Altmaier, Acting Director Fry and Task Force Members;

This letter discusses the captioned proposal concerning Instructions for Fund Investments. It is addressed both to the Valuation of Securities Task Force which has exposed this matter for comment until February 19, and the Capital Adequacy Task Force, to which it has been referred by the VOSTF.

C-1 Factors for bonds are based on the credit risks inherent in investing in debt instruments. Yet these same factors are being applied today to certain equity shares and the proposal is to apply the favorable bond C-1 factors to even more assets that are not actual bonds.

This letter compares the risks of investing in these two distinctly different asset classes. It also presents an alternative framework for developing new C-1 factors while not expressing any views as to the appropriateness of insurer investing in these assets.

While there may be an argument for treating closed end funds as if they were actual bonds for insurance regulatory purposes no reasonable argument can be made for bond-like treatment of open end funds (which include Exchange Traded Funds). At a minimum their inclusion, without rigorous review, would distort current measures and historical comparisons of RBC and could encourage insurers to invest in assets with unjustifiably low C-1 factors.

The investment characteristics of open end funds are those of equity interests and not debt instruments. These assets:

- Do not embody “creditor relationships” that are specified in SSAP 26;
- Do not have the same “predictability and periodicity” of cash flows of actual bonds which the SVO has cited as its standard for categorizing an asset as debt;
- Have indeterminate, not fixed, lives. Example: one year in the future a five year bond purchased today will be one year closer to repaying the principal promised to investors; a five year ETF will still be a five year ETF and there is no “principal” amount ever promised to be repaid;
Do not offer promises of cash flows that insurers can use to provide for their projected future liability needs;

Are not subject to “credit analysis” because there is no party to be evaluated making specific promises concerning the amounts of future cash flows;

Are not rated as if they were bonds by Nationally Recognized Statistical Rating Agencies (NRSROs). Some of these do compile the Weighted Average Risk Factors (WARFs) and assess dispersions of the assets within these structures but they do not rate them as if they were bonds;

Are being evaluated by the SVO based upon WARF factors which understate the investment risks actually presented by these securities;

Actively trade underlying bonds with the primary goal of minimizing the tracking error against the target index. Gain and loss-taking is a lessor consideration to the extent it is considered. This assures that the average length of the underlying holdings never shortens making it impossible to measure duration;

Are bought and sold at prevailing market prices so the uncertainty about the amount an investor will receive at the eventual time of sale is precisely the same as that for any other equity investment;

Are subject to market forces that will force loss-taking unlike bonds which, if held to maturity, are immune from market price volatility. (One example of the increased risk: higher interest rates);

Experience losses that will occur when the active manager must sell downgraded bonds within a fund to continue to match the fund’s benchmark. The C-1 modeling for direct holdings of bonds is based on losses expected when bonds default, not on losses given downgrades of bonds in a fund. The losses on downgraded bonds in a fund would be less severe but more frequent than losses given defaults. The NAIC has not determined which net loss would be greater, default risk of bonds or downgrade risk of funds. Given these completely different loss triggers and the uncertain consequences for funds there is no reasonable basis for applying bond C-1 factors to equity shares;

Are not treated as if they were bonds by any regulatory authority or standard setter of which I am aware except for the NAIC.

**Example**

Here is a hypothetical example demonstrating the difference between owning a real bond and an ETF containing bonds. If an insurer had invested one year ago in an actual five year bond it would have collected predictable interest payments and would now be four years from receiving the promised return of principal. The buyers last year of most five year ETFs containing bonds would be looking at losses with no promises as to the future.

<table>
<thead>
<tr>
<th>Remaining life as of 1/1/2019</th>
<th>Investment in a 5 Year Bond</th>
<th>Investment in Typical 5 Year ETF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Future Value</td>
<td>Four Years</td>
<td>Indefinite</td>
</tr>
<tr>
<td>2018 Income</td>
<td>$100 (par) in four years(^1)</td>
<td>Unknown</td>
</tr>
<tr>
<td>Value 1/1/2019</td>
<td>Amortized Cost</td>
<td>Loss(^2)</td>
</tr>
</tbody>
</table>

\(^1\) Subject to the risk of the issuer (credit risk)

\(^2\) Most ETFs containing bonds lost value in 2018

Certainly there are other differences between equity stakes in funds and actual debt instruments, but there are several arguments being made for treating these shares as if they were actual bonds.

First, it is noted that there is an exchange mechanism that allows owners of shares in ETFs to receive actual bonds in exchange for their ETFs. But isn’t this precisely the same as selling any other equity share (and realizing a gain or loss on that sale) and then purchasing real bonds? In other words the investor does not own a debt instrument unless and until it has made an exchange. Prior to that time it holds an equity interest, not debt, and it is subject to the risks associated with equities.
It is also claimed that over the long term holding ETFs with their indefinite lives resembles the dynamics of managing an investment portfolio containing bonds. Presumably the Total Rate of Return (TRR, a standard performance measure) would be the same for both the ETFs and the bond portfolio. Admittedly this probably would be the case; the TRRs would likely be very similar in the long run. The problem here is that the NAIC RBC structure is based on individual assets, not on portfolios or portfolio effects. The result is that treating ETFs as if they were bonds is incompatible with the fundamental structure of RBC for assets. It may be desirable to fundamentally alter the RBC structure to contemplate aggregations of assets rather than individual assets and this may accommodate ETFs. This, however, would represent a fundamental change which would be very difficult to implement.

Given that ETFs and other open end funds are not bonds is there a reasonable way to estimate their risk for RBC purposes?

We have established that the risk for these funds is not “credit risk”, but what is it? Due to the absence of a creditor relationship, essentially these assets pose the same risks as most other non-debt instruments and that is market risk. Since at the time of investment the values that will be received in the future are unknown, a reasonable approach is to do what has been done for RBC with other equity assets. Specifically, this is to look at historic price volatility. The greater the historic price volatility the greater the risk and conversely.

Practically, then, one can look at the historic price volatility of the index upon which a fund is based and that forms a starting point for the risk estimate. Fortunately price history is available. An additional risk element is tracking error (variance of the fund vs. its benchmark index) but this is generally very small and is also estimable.

Summary

Essentially, ETFs are nothing but mutual funds in a tax-advantaged wrapper. There is no more justification for “looking through” an open end fund, including an ETF, and using C-1 factors for its constituents than there would be for “looking through” a collateralized mortgage obligation (CMO) and treating it as if it were a collection of mortgage loans. In both cases the underlying assets have been transformed by an overlying structure which has altered not only the cash flows but the investment risks as well.

Conclusion

Fortunately it is possible to derive C-1 factors for open end funds, including ETFs, in generally the same manner as for other equity stakes. Accordingly the Task Force should make it clear that the application of bond factors for open end funds is inappropriate and where this is being done it should be discontinued even as the Capital Adequacy Task Force considers whether to develop appropriate risk factors for these equity interests.

Sincerely,

Christopher Anderson

copies: Ms. Jane Barr, Robert Carcano, Esq., Mr. Lou Felice, Ms Tessa Maier and Mr. Charles Therriault, CFA
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November 8, 2019

Commissioner David Altmaier
Chair of the Capital Adequacy Task Force

Attn: Jane Barr, NAIC – jbarr@naic.org

Re: Capital Adequacy Task Force Exposure of Request for Assignment of Bond Risk-Based Capital (RBC) Charges for Funds That Predominantly Hold Bonds

Dear Commissioner Altmaier,

We appreciate the opportunity to comment on the referral from the Valuation of Securities (E) Task Force requesting the assignment of bond RBC charges for funds that predominantly hold bonds, exposed by the Capital Adequacy (E) Task Force with a deadline of November 8, 2019.

On behalf of Everest Reinsurance, we express support for the application of bond RBC factors consistent with the SVO-determined fixed income designation for all bond and preferred stock funds and ETFs, both private and public, regardless of the Schedule they are reported on (Schedule BA, D-1, or D-2-2) as part of the recently adopted Comprehensive Funds Framework.

We agree with the valid arguments presented in the Valuation of Securities (E) Task Force referral, dated May 10, 2019, that focus on modernizing the treatment of commingled vehicles and providing a consistent approach to the RBC framework to improve information for regulatory oversight. In addition, we offer the following comments:

- A single fund of bonds or preferred stock could currently receive three different RBC charges due to being held in different legal forms (Schedule D-1 with an NAIC Designation if on the ETF Bond List, Schedule D-2-2 with equity RBC charge if a mutual fund, or Schedule BA with the appropriate charge if held in a private fund). This does not reflect actual differences in investment risk and reduces clarity for regulators to assess the Asset Risks of an insurer.

- Unnecessarily punitive RBC factors applied to bond and preferred stock private funds and mutual funds result in inefficient investments from insurers, particularly small and medium-sized insurers. Funds allow for smaller insurers to achieve better pricing economies of scale and diversification of investment risk than many can find by purchasing individual securities, but an RBC charge ~1.5x greater for the fund is a major impediment. Improving investment efficiency can also improve an insurer’s operations, access to liquidity, and overall financial strength.
- RBC factors are already being utilized by the Life Insurance RBC formula for Schedule BA assets that have received NAIC designations from the NAIC Securities Valuation Office (SVO). While each RBC model should be developed separately, the Life Risk-Based Capital (E) Working Group has determined that the current bond RBC factors are appropriate to apply to bond funds.

- In addition to Schedule BA assets for Life Insurance companies, RBC factors are applied to a multitude of investments that are not corporate bonds, including, but not limited to, municipal debt, asset- and mortgage-backed securities, foreign government debt, bond ETFs, hybrid debt, and preferred stock. Applying current bond RBC factors to SVO-assigned designations is consistent with the current investment RBC approach. Deciding to change the RBC factors for non-corporate debt is a separate discussion from incorporating NAIC designations for bond and preferred stock funds and ETFs into the RBC formulas for all insurance types.

- Lastly, an impact analysis would underrepresent the interest in this streamlining, as the inconsistency of the current regulatory framework favors only certain ETFs and individual bonds without regard to an investment’s economic or liquidity strengths or weaknesses. This causes insurers currently to avoid less capital-favorable investments – those investments are thus materially underrepresented on current insurer balance sheets. We would refer the Task Force to studies* documenting the increase in ETF investments for insurance companies after they were permitted for Schedule D-1 reporting and systematic value accounting. We are highly confident there will be material demand for fund use with the integration of comprehensive instructions for bond funds into the RBC capital framework due to consistent application of capital requirements based on accurate investment risk and liquidity features.

Thank you for your continued efforts toward the goal of ensuring consistent treatment for investments in funds that predominantly hold bonds across all schedules and all insurer types.

Best regards,

Jack M. Nelson
Chief Investment Officer

cc: Lou Felice, NAIC, Capital Adequacy (E) Task Force

October 23, 2019

Commissioner David Altmaier  
Chair of the Capital Adequacy Task Force

Attn: Jane Barr, NAIC – jbarr@naic.org

Re: Capital Adequacy Task Force Exposure of Request for Assignment of Bond Risk-Based Capital (RBC) Charges for Funds That Predominantly Hold Bonds

Dear Commissioner Altmaier,

We appreciate the opportunity to comment on the referral from the Valuation of Securities (E) Task Force requesting the assignment of bond RBC charges for funds that predominantly hold bonds, exposed by the Capital Adequacy (E) Task Force with a deadline of November 8, 2019.

On behalf of Payden & Rygel and our insurance clients, we express support for the application of bond RBC factors consistent with the SVO-determined fixed income designation for all bond and preferred stock funds and ETFs, both private and public, regardless of the Schedule they are reported on (Schedule BA, D-1, or D-2-2) as part of the recently adopted Comprehensive Funds Framework.

We agree with the valid arguments presented in the Valuation of Securities (E) Task Force referral, dated May 10, 2019, that focus on modernizing the treatment of commingled vehicles and providing a consistent approach to the RBC framework to improve information for regulatory oversight. In addition, we offer the following comments:

- A single fund of bonds or preferred stock could currently receive three different RBC charges due to being held in different legal forms (Schedule D-1 with an NAIC Designation if on the ETF Bond List, Schedule D-2-2 with equity RBC charge if a mutual fund, or Schedule BA with the appropriate charge if held in a private fund). This does not reflect actual differences in investment risk and reduces clarity for regulators to assess the Asset Risks of an insurer.

- Unnecessarily punitive RBC factors applied to bond and preferred stock private funds and mutual funds result in inefficient investments from insurers, particularly small and medium-sized insurers. Funds allow for smaller insurers to achieve better pricing economies of scale and diversification of investment risk than many can find by purchasing individual securities, but an RBC charge ~15x greater for the fund is a major impediment. Improving investment efficiency can also improve an insurer’s operations, access to liquidity, and overall financial strength.

Payden&Rygel
Los Angeles | Boston | London | Milan
265 Franklin Street • Boston, Massachusetts 02110 • 617.807.1990
- **RBC factors are already being utilized by the Life Insurance RBC formula** for Schedule BA assets that have received NAIC designations from the NAIC Securities Valuation Office (SVO). While each RBC model should be developed separately, the Life Risk-Based Capital (E) Working Group has determined that the current bond RBC factors are appropriate to apply to bond funds.

- In addition to Schedule BA assets for Life Insurance companies, RBC factors are applied to a multitude of investments that are not corporate bonds, including, but not limited to, municipal debt, asset- and mortgage-backed securities, foreign government debt, bond ETFs, hybrid debt, and preferred stock. **Applying current bond RBC factors to SVO-assigned designations is consistent with the current investment RBC approach.** Deciding to change the RBC factors for non-corporate debt is a separate discussion from incorporating NAIC designations for bond and preferred stock funds and ETFs into the RBC formulas for all insurance types.

- Lastly, an impact analysis would underrepresent the interest in this streamlining, as the inconsistency of the current regulatory framework favors only certain ETFs and individual bonds without regard to an investment’s economic or liquidity strengths or weaknesses. This causes insurers currently to avoid less capital-favorable investments – those investments are thus materially underrepresented on current insurer balance sheets. We would refer the Task Force to studies* documenting the increase in ETF investments for insurance companies after they were permitted for Schedule D-1 reporting and systematic value accounting. We are highly confident there will be material demand for fund use with the integration of comprehensive instructions for bond funds into the RBC capital framework due to consistent application of capital requirements based on accurate investment risk and liquidity features.

Thank you for your continued efforts toward the goal of ensuring consistent treatment for investments in funds that predominantly hold bonds across all schedules and all insurer types.

Best regards,

Erinn R. King, CFA
Managing Principal, Payden & Rygel

Eric M. Hovey, CFA
Senior Vice President, Payden & Rygel

cc: Todd Kiser, Vice Chair, Capital Adequacy (E) Task Force
Lou Felice, NAIC, Capital Adequacy (E) Task Force
Kevin Fry, Chair, Valuation of Securities (E) Task Force

November 8, 2019

VIA ELECTRONIC MAIL
Capital Adequacy (E) Task Force (CAPAD)
c/o National Association of Insurance Commissioners (NAIC)
Jane Barr and Lou Felice

Re: Referral from Valuation of Securities (E) Task Force (VOSTF) to the Capital Adequacy (E) Task Force – Request for Assignment of Risk-Based Capital (RBC) Charges for Funds That Predominantly Hold Bonds

Dear Task Force members and NAIC staff,

Vanguard\(^1\) is writing to express our continued support for the NAIC’s amendment to the P&P Manual that added comprehensive instructions for fund investments, permitting insurers to report an SVO-assigned designation for bond mutual funds, and for the VOSTF request that these designations carry corresponding “bond-like” RBC charges.

Vanguard previously commented on this topic during the Statutory Accounting Principles (E) Working Group’s investment classification project, and again during prior exposure periods as the VOSTF broadly assessed the matter and the SVO worked towards a comprehensive proposal. Vanguard supports the NAIC’s approach to classify these investments as “fixed-income like” for reporting and accounting purposes, and recommendation to afford RBC charges indicative of the underlying holdings, which are bonds.

Substantively, the risks of fund investments are a reflection of the investments of their underlying portfolios. Consequently, there is no reason to treat them differently from a risk standpoint, nor any benefit to the insurer community. All should be eligible for designation assignment based on their underlying investments, reliant on a proven historical process and evaluation methodology that dates back almost 30 years. Adoption of this proposed approach will foster greater competition among investment managers, leading to lower investment costs and improved access to professional management choices for insurers, built on a sound process foundation with strong regulatory protections. Attached is a visual summarizing previous Vanguard comments, VOSTF referral points, and potential impact.

Vanguard appreciates the opportunity afforded by the NAIC to offer comments on important regulatory issues that impact our clients and the insurance industry as a whole. We would welcome further discussion with NAIC staff and task force members.

Sincerely,

Kelly M. Sweppenhiser, CFA, CAIA
Head of Insurance General Account Solutions
Vanguard Institutional Investor Group

\(^1\) Vanguard is one of the world’s leading asset managers, managing over $5 trillion on behalf of more than 20 million investors worldwide, including more than $18 billion on behalf of over 500 insurance companies.
Request for Assignment of Risk-Based Capital (RBC) Charges for Funds That Predominantly Hold Bonds

Summary: Vanguard supports the Valuation of Securities (E) Task Force (VOSTF) request of the Capital Adequacy (E) Task Force to attribute bond RBC factors (used as a proxy) to all bond funds that are now eligible in the P&P Manual for Securities Valuation Office (SVO) evaluation. This approach is consistent with past NAIC practices that recognize both the role of the VOSTF in identifying the risks in securities and the practical approach expressed in the administration of the RBC framework.

Consideration

Align to like bond funds
- Other funds, which predominantly hold bonds (bond ETFs, government bond mutual funds), are eligible to receive “bond-like” capital treatment
- Bond mutual funds currently receive “common stock” charge even though they hold only or predominantly individual bonds

Successful precedent of risk analysis
- Almost 30 years of SVO quantitative and qualitative risk evaluation and process refinement for bond securities
- 15 years of “bond-like” designations and RBC for bond ETFs

Impact

Increased consistency and decreased insurer confusion which aligns with NAIC goals and reduces unwarranted insurer inquiries

Removal of incentive for the use of a specific fund vehicle (ETF) based on different capital treatment while still providing accurate monitoring of insurer capitalization

Ease of implementation due to precedent and established, comprehensive SVO process

Minimal risk due to the proven track record

Minimal impact to current insurer RBC by potentially only adjusting insurer required capital for funds that apply for designations – at maximum this would represent less than 1/10 of 1% (0.001%) of net admitted assets

Invested assets will be limited with slow allocation increase as a small subset of SEC-registered bond mutual funds will submit for designation

Invested assets
- $4B insurer invested assets in bond mutual funds 12/31/2018
- NAIC designation and RBC assignment is contingent on mutual fund managers undergoing RTAS process – only 163 bond ETFs have applied after 15 years of allowance
- Regulation exists limiting insurer invested assets

1) Vanguard calculation based on 2018 S&P Global statutory filing data
2) Source: NAIC ETF Bond List, as of October 7, 2019
TO: Commissioner David Altmaier (FL), Chair of the Capital Adequacy (E) Task Force
Kevin Fry, (IL), Chair of the Valuation of Securities (E) Task Force
FROM: Dale Bruggeman (OH), Chair of the Statutory Accounting Principles (E) Working Group
DATE: April 16, 2019
RE: Ref #2018-18 – Structured Notes

During the 2019 Spring National Meeting, the Statutory Accounting Principles (E) Working Group adopted as final, agenda item 2018-18, Structured Notes to clarify the accounting and reporting guidance for structured notes. Pursuant to the adopted definition, a structured note is defined as an investment that is structured to resemble a debt instrument, where the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due. Structured notes reflect derivative instruments (i.e. put option or forward contract) that are wrapped by a debt structure. The adopted revisions include the following:

1. **SSAP No. 2R—Cash, Drafts, and Short-term Investments**: Derivative instruments shall not be reported as cash equivalents or short-term instruments regardless of their maturity date.

2. **SSAP No. 26R—Bonds**: Structured notes are explicitly excluded from the scope of SSAP No. 26R. Although these instruments are structured to resemble a debt instrument with a “debt wrapper” these instruments are not bonds.

3. **SSAP No. 43R—Loan-Backed and Structured Securities**: Structured notes that are mortgage-referenced securities are in scope of SSAP No. 43R.

4. **SSAP No. 86—Derivatives**: Structured notes, excluding mortgage-referenced securities in scope of SSAP No. 43R, are considered derivative instruments and shall be captured in scope of SSAP No. 86.

The adopted statutory accounting revisions were adopted with a Dec. 31, 2019 effective date. A blanks proposal was also exposed at the Spring National Meeting to incorporate new reporting lines on Schedule D, Part 1 to separately identify mortgage-referenced securities reported within the scope of SSAP No. 43R.

With adoption of the revisions, the Working Group directed a referral to the Capital Adequacy (E) Task Force and the Valuation of Securities (E) Task Force:

- **Capital Adequacy (E) Task Force** – The Working Group has identified that the book/adjusted carrying value (BACV) of a structured note reported on Schedule DB will be fair value (and likely captured as an “other” derivative), and RBC will be determined based on the reported BACV. With a structured note, the principal amount to be returned is contingent on the specific performance of an underlying variable as of a stated date. So, although structured to resemble a debt instrument, interest and the return of principal (original investment amount) may only occur if underlying variable (often an equity index) meets a performance threshold on a designated date. Furthermore, the Working Group identified that the IMR/AVR annual statement instructions only address hedging, income generation and replication derivatives. This referral requests consideration of appropriate RBC charges, and the elements used in determining the RBC (perhaps considering “potential exposure” instead of BACV”), for structured notes.
Valuation of Securities (E) Task Force – With the adoption of a structured note definition in SSAP No. 26R and SSAP No. 86, the Working Group requests that the Task Force revise the structured note definition in the Purposes and Procedures Manual of the Investment Analysis Office. The Working Group requests that the Task Force mirror the adopted statutory accounting definitions or simply refer to the SSAP No. 86 definition to ensure continuity.

**SSAP No. 26R—Bonds**

2. This statement excludes:
   c. Securities that meet the definition in paragraph 3, **but for which the contractual amount of the instrument to be paid at maturity (or the original investment) is at risk for other than failure of the borrower to pay the contractual amount due.** These investments, although in the form of a debt instrument, incorporate risk of an underlying variable in the terms of the agreement, and the issuer obligation to return the full principal is contingent on the performance of the underlying variable. **These investments are addressed in SSAP No. 86—Derivatives, unless the investment is a mortgage-referenced security addressed in SSAP No. 43R.** This exclusion is specific to instruments in which the terms of the agreement make it possible that the reporting entity could lose all or a portion of its principal amount due / original investment amount (for other than failure of the issuer to pay the contractual amounts due). These instruments incorporate both the credit risk of the issuer, as well as the risk of an underlying variable (such as the performance of an equity index or the performance of an unrelated security). Securities that are labeled “principal-protected notes” are captured within this exclusion if the “principal protection” involves only a portion of the principal / original investment amount and/or if the protection requires the reporting entity to meet qualifying conditions in order to be safeguarded from the risk of loss from the underlying linked variable. Securities that may have changing positive interest rates in response to a linked underlying variable or the passage of time, or that have the potential for increased principal repayments in response to a linked variable (such as U.S. Treasury Inflation-Indexed Securities) that do not incorporate risk of original investment / principal loss (outside of default risk) are not captured in this exclusion. Securities within the scope of SSAP No. 43R, foreign denominated bonds (if only by virtue of their denomination in a foreign currency) and securities comprising elements of risk consistent with Replication (Synthetic Assets) transactions (RSATs), as defined in the Purposes and Procedures Manual of the NAIC Investment Analysis Office, are also not captured in this exclusion. This exclusion does not impact RSATs as defined in SSAP No. 86.

**SSAP No. 86—Derivatives**

5. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures, structured notes with risk of principal / original investment loss based on the terms of the agreement (in addition to default risk), and any other agreements or instruments substantially similar thereto or any series or combination thereof.

   g. **“Structured Notes” in scope of this statement are instruments (often in the form of debt instruments), in which the amount of principal repayment or return of original investment is contingent on an underlying variable/interest.** Structured notes that are “mortgage-referenced securities” are captured in SSAP No. 43R—Loan-backed and Structured Securities.

Footnote: The “structured notes” captured within scope of this statement is specific to instruments in which the terms of the agreement make it possible that the reporting entity could lose all or a portion of its original investment amount (for other than failure of the issuer to pay...
Please contact NAIC staff of the Statutory Accounting Principles (E) Working Group with any questions.

cc Julie Gann, Robin Marcotte, Fatima Sediqzad, Jake Stultz, Jane Barr, Charles Therriault

Attachment: Agenda Item 2018-18

G:\FRS\DATA\Stat Acctg\1. Statutory\E. Referrals\2019\2019 SAPWG to VOS CapAd - Structured Notes.doc
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November 8, 2019

Honorable David Altmaier, Chair
NAIC Capital Adequacy (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Honorable Todd E. Kiser, Vice Chair
NAIC Capital Adequacy (E) Task Force
1100 Walnut Street
Suite 1500
Kansas City, MO 64016-2197

Re: Capital Adequacy Task Force Exposure – Ref #2018-18: Structured Notes

Dear Commissioner Altmaier and Commissioner Kiser:

The American Council of Life Insurers (ACLI)1 and the North American Securities Valuation Association (NASVA)2 (“the undersigned”) appreciate the opportunity to comment on the Capital Adequacy Task Force paper related to Statutory Accounting Principles Working Group (“SAPWG”) Ref. #2018-18, Structured Notes. In May 2019, SAPWG also exposed Ref. #2019-18, which included additional proposed revisions to the accounting and reporting for Structured Notes. The exposure included revisions to SSAP 86, Derivatives, proposing that Structured Notes3 be reported as “Other Derivatives” on Schedule DB and, per

1 The American Council of Life Insurers (ACLI) advocates on behalf of 280 member companies dedicated to providing products and services that promote consumers’ financial and retirement security. 90 million American families depend on our members for life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, dental and vision and other supplemental benefits. ACLI represents member companies in state, federal and international forums for public policy that supports the industry marketplace and the families that rely on life insurers’ products for peace of mind. ACLI members represent 95 percent of industry assets in the United States. Learn more at www.acli.com.

2 The North American Securities Valuation Association (NASVA) is an association of insurance company representatives who interact with the National Association of Insurance Commissioners Securities Valuation Office to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC’s ISIS electronic security filing system, and commenting on year-end processes.

3 Structured Notes were defined in Ref. #2018-18 in SSAP 86 as instruments (often in the form of a debt instrument) in which the amount of principal repayment or return of original investment is contingent on an underlying variable/interest. Terms of the agreement make it possible that the reporting entity could lose all or a portion of its original investment amount (for other than failure of the issuer to pay the contractual amounts due). These instruments incorporate both the credit risk of the issuer, as well as the risk of an underlying variable/interest (such as the performance of an equity index or the performance of an unrelated security). Securities that are labeled “principal-protected notes” are captured within the scope of this statement if the “principal protection” involves only a portion of the principal and/or if the principal protection requires the reporting entity to meet qualifying conditions in order to be safeguarded from the risk of loss form the underlying linked variable. Securities that may have changing interest rates in response to a linked underlying variable, or that have the potential for increased principal repayments in response to a linked variable (such as U.S. Treasury inflation-indexed Securities) that do not incorporate risk of original investment/principal loss (outside of default risk) are not captured in scope of this statement.
the proposed paragraph 19 of SSAP 86, that they be accounted for at fair value with changes in fair value recorded as unrealized gains and losses. The proposal also recommended that Structured Notes be reported as non-admitted assets.

The undersigned have supported and continue to support the broader Interested Parties group (“IPs”) comment letters on the various Structured Notes exposures discussed above. In summary, the IPs agreed with the definition of Structured Notes and that, given their unique nature, Structured Notes be reported at fair value. However, the IPs noted that they continued to be concerned about potential unintended consequences of the cliff effect (potential non-admission of a bond with a trivial embedded derivative) as capital markets develop. Should problems develop, the IPs requested to re-examine the issue. The undersigned are not as concerned at this time about the proposal to non-admit Structured Notes given the insignificant number/amounts of such investments in insurers’ investment portfolios. The undersigned have discussed that non-admitting investments, which are acceptable investments in the Investment Laws, only because principal is at risk is a precedence for which we have concerns and thus we would re-examine the issue should it become more prevalent in the future.

In situations where an insurer reports Structured Notes on Schedule DB as “Other Derivatives” at fair value with changes in fair value reported as unrealized gains and losses, with the remaining fair value being non-admitted, similar to other assets/investments that are non-admitted in P&C companies, no Risk-Based Capital (“RBC”) should be applied to the instrument. This is appropriate because the net carrying value for the investment (net of the non-admit) is zero. The RBC rules for P&C companies refer to the net book/adjusted carrying values (net of a non-admit amount) when calculating RBC charges. We believe there are instances of inconsistent treatment within the Life RBC formula in that, even though an asset may be non-admitted (reducing Statutory Capital and Surplus by 100% of the net book/adjusted carrying value of the asset), the gross asset (before reducing it for non-admitting) has a RBC charge associated with it. We suggest the Life RBC forms and instructions be reviewed and modified to eliminate instances where an RBC charge is applied to a non-admitted asset carry value. This would ensure consistent handling of non-admit amounts across all asset classes within the Life RBC formula and would mirror the P&C company rules.

Should an insurer receive a permitted practice to admit Structured Notes as “Other Derivatives”, we recommend the RBC rules associated with Derivatives on Schedule DB be modified to treat such instruments like equity securities (e.g., Life RBC of 30%). We propose equity RBC treatment versus Schedule DB RBC treatment for the following key reasons (no reason is determinative on its own):

- Applying the highest RBC charge would provide more comparability to those insurers who do not receive a prescribed practice and must non-admit the investments (i.e., 100% reduction to Statutory Capital).
- The principal for Structured Notes is primarily at risk of loss for other than credit risk of the issuer.
- The existing RBC rules for derivatives in SSAP 86 are not as relevant to these instruments because they consider if book/adjusted carrying value is positive or negative (negative carrying value is not relevant to Structured Notes as their fair values may not be negative) and consider amount of collateral posted (not relevant to Structured Notes).

We appreciate the opportunity to provide comments on this topic and would be happy to discuss any aspect of our letter with you.

Sincerely,

Tracey Lindsey
President
North American Securities Valuation Association

Senior Director, Accounting Policy
American Council of Life Insurers

cc: Ms. Jane Barr, NAIC Company Licensing and RBC Manager