NAIC NATIONAL MEETING SUMMER 2022

Date: 8/3/22

2022 Summer National Meeting
Portland, Oregon

RISK-BASED CAPITAL INVESTMENT RISK AND EVALUATION (E) WORKING GROUP
Thursday, August 11, 2022
9:30 – 10:30 a.m.
Portland Ballroom 252-253 - Level 2 - Oregon Convention Center

ROLL CALL

Philip Barlow, Chair	District of Columbia	William Leung/Debbie Doggett	Missouri
Thomas Reedy	California	Lindsay Crawford	Nebraska
Wanchin Chou	Connecticut	Bob Kasinow/Bill Carmello	New York
Ray Spudeck/Carolyn Morgan	Florida	Dale Bruggeman/Tom Botsko	Ohio
Vincent Tsang	Illinois	Mike Boerner/Rachel Hemphill	Texas
Carrie Mears	Iowa	Steve Drutz/Tim Hays	Washington
Fred Andersen	Minnesota	Amy Malm	Wisconsin

NAIC Support Staff: Dave Fleming/Julie Gann/Charles Therriault/Linda Phelps/Peter Kelly

AGENDA

1. Consider Adoption of its Spring National Meeting Minutes—*Philip Barlow (DC)* Attachment A

2. Discuss its Working Agenda—*Philip Barlow (DC)* Attachment B

3. Receive Updates from the Valuation of Securities (E) Task Force and the Statutory Accounting Principles (E) Working Group—*Philip Barlow (DC)*

4. Discuss Next Steps—*Philip Barlow (DC)*

5. Discuss Any Other Matters Brought Before the Working Group—*Philip Barlow (DC)* Attachment C

6. Adjournment

Draft Pending Adoption

Attachment XX
Capital Adequacy (E) Task Force
--/XX/22

Draft: 4/4/22

Risk-Based Capital Investment Risk and Evaluation (E) Working Group
Virtual Meeting (*in lieu of meeting at the 2022 Spring National Meeting*)
March 22, 2022

The Risk-Based Capital Investment Risk and Evaluation (E) Working Group of the Capital Adequacy (E) Task Force met March 22, 2022. The following Working Group members participated: Philip Barlow, Chair (DC); Thomas Reedy (CA); Wanchin Chou (CT); Ray Spudeck (FL); Carrie Mears (IA); Vincent Tsang (IL); Fred Andersen (MN); William Leung and Debbie Doggett (MO); Lindsay Crawford (NE); Bill Carmello and Bob Kasinow (NY); Dale Bruggeman and Tom Botsko (OH); Mike Boerner (TX); Steve Drutz and Tim Hays (WA); and Amy Malm (WI).

1. Adopted its Feb. 28 Minutes

The Working Group met Feb. 28. During this meeting, the Working Group took the following action: 1) discussed overall charges and the Financial Condition (E) Committee's direction; 2) heard a preliminary investment overview and member perspectives; and 3) received comments from an initial request related to risk-based capital (RBC) treatment for asset-backed securities (ABS).

Mr. Spudeck made a motion, seconded by Mr. Chou, to adopt the Working Group's Feb. 28 minutes (Attachment Seven-A). The motion passed unanimously.

2. Discussed Comments Received

a. American Council of Life Insurers

Paul Graham (American Council of Life Insurers—ACLI) presented the ACLI's comment letter (Attachment Seven-B). He noted the significant complexity involved in developing RBC for ABS. He noted the determination of associated risks (i.e., loss given default, timing, and others) will be different from commercial bonds. He said collateralized loan obligations (CLOs) might be able to be mapped to current bond factors using what has been learned from commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS) modeling. He suggested addressing CLOs first with other ABS to follow. He noted that RBC has historically followed the rule of rough justice and underscored the fact that the purpose of RBC is to identify weakly capitalized companies. He noted the ACLI's suggestion that a technical resource group could be formed to help get the project started, defining scope, risks to study, and how this work fits within the RBC framework.

b. Bridgeway Analytics

Amnon Levy (Bridgeway Analytics) presented Bridgeway Analytics' comments (Attachment Seven-C). He indicated support for the comments by Mr. Graham and the ACLI on a phased approach, allowing for coordination with the related review of nationally recognized statistical rating organizations (NRSROs) use in Securities Valuation Office (SVO) designations and acknowledging the complexity of the issues involved. He highlighted the need for the framework to be consistent with its use and measurement of differentiated risk measures, including that of a single credit investment (e.g., a rating and thus designation), and a portfolio loss concept that considers diversification and concentration (e.g., c1 factors). With respect to the RBC framework and providing state insurance regulators better tools to identify weakly capitalized companies and align investment incentives, he highlighted the need for ongoing monitoring of tail risks that can change materially from year to year with varying

risk factors and to a varying degree across RMBS, CMBS, CLOs, and other structured assets. He also noted risks that are not captured by ratings, and thus NAIC designations. He said the approach should be sensitive to volatility and cyclical fluctuations. He stated that the data on ratings, and thus NAIC designations, that are fundamental to C-1 RBC are particularly sparse for structured assets. By and large, NRSRO methodologies were modified substantially after the financial crisis, with few credit events since. With data on collateral experience generally more robust than tranche experience, Mr. Levy said Bridgeway Analytics believes reliance on model-based approaches can better capture nuanced and varying characteristics across structured asset segments.

c. Risk & Regulatory Consulting

Ed Toy (Risk & Regulatory Consulting—RRC) presented RRC's comments (Attachment Seven-D). He said the RBC framework was originally intended as a regulatory tool to be able to see weakly capitalized companies, and the framework was not intended to be granular or very detailed. However, he stated that investment vehicles owned by insurers have grown more varied and investment practices more complex. With this consideration, he said some degree of increased detail may be warranted to avoid regulatory arbitrage. He said a big step was already completed with the increased granularity of NAIC bond designations, as that eliminated the inappropriate incentive to race to the bottom with investments with BBB-minus designations and the disincentive to lean towards BBB-plus bonds.

Mr. Toy stated support for the review of the RBC framework to ensure that complex assets have RBC charges that are commensurate with the risk. He said structured securities are one of the investments where additional attention may be appropriate, but he encouraged the Working Group to think holistically and consider the broader themes mentioned by Mr. Graham. Mr. Toy stated that there are different kinds of risk and that tail risk is potentially different for different assets. While tail risk includes differences in volatility for default risk, he said the major issue is differences in loss severity. He stated that higher-level classes of structured securities are not perceived to be a material area of concern, and the primary issue is with subordinate classes. As such, understanding the industry exposure to subordinate classes of structured securities and how the characteristics of these investments compare with other asset classes that are also potentially concerning may be beneficial. Mr. Toy provided examples of collateral loans, which have a flat RBC factor for life entities and construction mortgage loans as two asset classes that have also had significant growth. Looking at asset classes with high tail risk, he also inquired about the assessment of asset classes that have materially less tail risk, such as government bonds. He said focusing on particular asset classes with specific risks without having a holistic discussion may create imbalances in the formula.

Mr. Toy stated that understanding the focus of tail risk is also a key element. If the focus is loss severity, then the question that should be addressed is how loss severity translates into a risk of loss to surplus, which is the main issue for RBC. He stated that if an insurer owns an investment at significant discount to par, then the risk of loss to surplus may be different from another insurer that owns the same investment at par.

Mr. Toy said the overall discussion should begin with representatives of the American Academy of Actuaries (Academy), and if there is a need to focus on specific areas, then engaging a consulting actuary may make sense.

Mr. Toy also addressed the specific question of residuals, which is a subcategory of structured securities. He stated that as classes are the bottom supporting tranche in a capital structure, then treatment as equity makes sense. With regard to Mr. Toy's question regarding the reporting of residuals, Mr. Bruggeman said there are two proposals being considered for adoption at the Blanks (E) Working Group. These proposals will require classification of residuals on Schedule BA and asset valuation reserve (AVR) based on underlying characteristics.

The proposals mirror existing underlying classifications as fixed income, common stock, real estate, mortgage loans, and other. Mr. Toy commented that more granular classifications, particularly for the common stock category, may be warranted, providing an example of differences between publicly traded and private common stock investments. He stated having the same factor for the various stock or equity backed assets highlights the point of focusing on underlying risks.

d. FLOIR

Mr. Spudeck presented comments (Attachment Seven-E) from the Florida Office of Insurance Regulation (FLOIR). He said with the progression and innovation towards more complicated investments, this is an opportunity to dig into the use of NAIC designations ,as well as the classification of assets. He stated that the focus should be on the risk to surplus and ultimately the risk to policyholders or the insurer's capital position. He stated that this project is likely going to be a long process but one that is overdue. Mr. Spudeck stated that it may appropriate to start with current asset exposures, but he said current exposures should not drive the work as that prevents considering issues or exposures that are currently being designed or developed until they have permeated the industry. He said waiting for items to be widespread makes it more difficult for the regulatory community to craft a nimble, agile, and efficient response to get the asset class reflected to where it should have been in the first place.

3. Adopted its Working Agenda

Mr. Barlow presented the Working Group's working agenda and said it includes items referred from the Financial Condition (E) Committee and prior referrals to the Capital Adequacy (E) Task Force that focused on investments. He said the referrals from the Committee, as they include timelines, are recommended to be addressed first. However, to be consistent with many of the comments made, he said he recommends a holistic review as an overall approach.

Mr. Drutz made a motion, seconded by Mr. Botsko, to adopt the Working Group's working agenda (Attachment Seven-F).

4. Discussed its Next Steps

Mr. Barlow said the Working Group will begin with a review of the projects requested from the Committee. He stated support for a holistic review and supported Mr. Spudeck's comment to review the role of NAIC designations and how assets are classified as part of this process. He said it would be key to identify the risks of asset classes and the impact on the solvency of insurance companies. He stated support for a process that allows consideration of new assets as they come into insurance company portfolios. He said it would be ideal if the revised process would prevent application of RBC factors based on an NAIC designation or asset classification that is ultimately not appropriate for the asset's risk. He echoed the comments from Mr. Graham that it will not be possible to be perfect, but the goal is to have reasonable charges that are not too high or too low based on the risk of the asset. He stated that the process will be complicated, and that the assessment needs to consider the overall impact to the financial statements, reserves, and overall capital and surplus of insurance companies to be in line with the goal of RBC to identify weakly capitalized companies, or to identify actions that move companies towards being weakly capitalized.

Mr. Tsang asked about the percentage of these complex assets currently owned by insurance companies. Mr. Barlow stated that there is work being done to better determine how these assets are identified in the financial statements. He stated that improving consistency in the financial statements is key, as similar types of

assets may be reported differently. Charles Therriault (NAIC) stated that the Working Group does not have an exact number, but he will further inquire with the Capital Markets Bureau. He stated that reporting consistency is one of the challenges, as reporting is inconsistent, and it is not always clear that the reported asset is a structured or complex security. He stated that these investments are often mixed in with other corporate bonds in the reporting structure.

Mr. Tsang asked whether it was feasible to apply a factor to these securities and whether some form of simulation analysis to evaluate the risk of these assets would be more appropriate. He said a structured security is not like a corporate bond, and it will be difficult to determine an appropriate factor when there are many variants among the different types of structures. Mr. Barlow stated that this is a good point, but his preference would be to try to determine a methodology to apply a factor. He said this process could result with use of current factors or could result with the creation of a whole new set of factors, but he would like to see if that is possible before moving to something more complicated, particularly as the magnitude of these investments is still uncertain. He said developing a complicated methodology for a limited number of assets would not be relevant in identifying weakly capitalized companies. Mr. Therriault said they will work to develop an assessment of exposure. He said the structured security group would also be well positioned to model these types of transactions and assess risks.

Mr. Tsang stated that another working group is also monitoring these structured securities for cash-flow testing. He asked whether the actions of that group, particularly if it puts a cap on structured assets for cash-flow testing, would affect the consideration of this Working Group. He stated that he would not want a revised factor from this Working Group and an updated actuarial guideline from another group to impede each other. Mr. Barlow stated that it is important to coordinate with the Statutory Accounting Principles (E) Working Group, the Valuation of Securities (E) Task Force, and the work that is being done to the reserves and how it might ultimately affect the solvency of an insurance company. He said this Working Group has representatives from a variety of groups to make sure that the right people are involved and that the discussions include all relevant information.

Mr. Barlow said the next steps would be the development of recommendations with suggestions on moving forward. As to whether it would be beneficial to have small subgroups focusing on specific areas, he said he would like to begin working at the full Working Group level, and if projects became too cumbersome, then perhaps small groups could be considered. Mr. Carmello, Ms. Mears, and Mr. Boerner all stated agreement with keeping the discussion initially within the full Working Group in developing recommendations. Mr. Barlow said specific agendas for key topics will be developed to allow progress through a project plan. He said he does not think the Working Group is at the point where a consultant would be beneficial, so he recommends putting that consideration aside for the time being. He said as the Working Group moves forward, there may be a better understanding of the services and assistance a consultant could provide. Mr. Wanchin agreed with future consideration of a consultant after the Working Group can define the scope of the project and determine the experts who can help achieve specific goals. Mr. Spudeck agreed, noting that it would be more efficient to first determine the information needed prior to engaging a consultant. John DuBois (MassMutual) suggested that framing the project by determining the size of the different asset classes may assist the next discussion. Mr. Barlow said the Working Group should expect meetings to be scheduled after the Spring National Meeting with specific agendas and goals noted for each meeting.

5. Discussed Other Matters

James Braue (United Health Group) asked whether this Working Group would also be considering parallel treatment to the AVR for the asset classes that are being considered for revised RBC. Mr. Barlow stated that this would occur on the life side.

Julie Gann (NAIC) said the Blanks Working Group (E) is scheduled to meet March 29, and two proposals up for adoption related to residual reporting on Schedule BA and AVR are available on the Working Group's website.

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

SharePoint/NAIC Support Staff Hub/Member Meetings/2022 Spring National Meeting/RBCIREWG 3-22-22 Minutes.docx

Priority 1 – High priority

Priority 2 – Medium priority

Priority 3 – Low priority

RISK-BASED CAPITAL INVESTMENT RISK AND EVALUATION (E) WORKING GROUP
WORKING AGENDA ITEMS FOR CALENDAR YEAR 2022

Attachment B
Capital Adequacy (E) Task Force

2022 #	Owner	2022 Priority	Expected Completion Date	Working Agenda Item	Source	Comments	Date Added to Agenda
				Carryover Items – RBC IR &E			
8	RBC IRE	2	2022 or Later	Supplementary Investment Risks Interrogatories (SIRI)	**Referred from CADTF** Referral from Blackrock and IL DOI	The Task Force received the referral on Oct. 27. This referral will be tabled until the bond factors have been adopted and the TF will conduct a holistic review all investment referrals.	**1/12/2022** 11/19/2020
9	RBC IRE	2	2022 or Later	NAIC Designation for Schedule D, Part 2 Section 2 - Common Stocks Equity investments that have an underlying bond characteristic should have a lower RBC charge? Similar to existing guidance for SVO-identified ETFs reported on Schedule D-1, are treated as bonds.	**Referred from CADTF** Referral from SAPWG 8/13/2018	10/8/19 - Exposed for a 30-day Comment period ending 11/8/2019 3-22-20 - Tabled discussion pending adoption of the bond structure and factors.	**1/12/2022** 10/11/2018
10	RBC IRE	2	2022 or Later	Structured Notes - 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.	**Referred from CADTF** Referral from SAPWG April 16, 2019	10/8/19 - Exposed for a 30-day Comment period ending 11/8/2019 3-22-20 - Tabled discussion pending adoption of the bond structure and factors.	**1/12/2022** 8/4/2019
11	RBC IRE	2	2022 or Later	Comprehensive Fund Review for investments reported on Schedule D Pt 2 Sn2	**Referred from CADTF** Referral from VOSTF 9/21/2018	Discussed during Spring Mtg. NAIC staff to do analysis. 10/8/19 - Exposed for a 30-day comment period ending 11/8/19 3-22-20 - Tabled discussion pending adoption of the bond structure and factors.	**1/12/2022** 11/16/2018
				Ongoing Items – RBC IR&E			
				New Items - RBC IR &E			
12			2023 or later	Evaluate the appropriate RBC treatment of Asset-Backed Securites (ABS), including Collateralized Loan Obligations (CLO), collateriazed fund obliations (CFOs), or other similar securites carrying similar types of tail risk (Complex Assets).	Request from E Committee, SAPWG, VOSTF	Per the request of E Committee comments were solictied asking if these typs of assets should be considered a part of the RBC framework.	1/12/2022
13			**2023 or later**	**Evaluate the appropriate RBC treatment of Residual Tranches.**	**Request from E Committee, SAPWG, VOSTF**	**Per the request of E Committee comments were solictied asking if these typs of assets should be considered a part of the RBC framework.**	**1/12/2022**
14			2025 or later	Phase 2 Bond analysis - evaluate and develop an approach to map other ABS to current bond factors following the establised principles from Phase I where the collateral has an assigned RBC. This project will likely require an outside consultant and the timeline could exceeds 2-3 years.	Request from E Committee	Per the request of E Committee commest were solicited requesting the need for outside review.	1/12/2022

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Philip Barlow, RBC Investment Risk & Evaluation (E) Working Group Chair

From: Marlene Caride, Commissioner, Financial Stability (E) Task Force Chair and

Justin Schrader, Macroprudential (E) Working Group Chair

CC: NAIC Support Staff: Dave Fleming/Julie Gann/Charles Therriault/Linda Phelps/Peter Kelly

Date: July 21, 2022

Re: Referral from the Plan for the List of MWG Considerations

The NAIC Macroprudential (E) Working Group (MWG) of the Financial Stability (E) Task Force (FSTF) was charged with coordinating the various NAIC activities related to private equity (PE) owned insurers. As an initial step, the MWG developed a list of 13 regulatory considerations. These considerations are frequently referenced as private equity (PE) concerns, but the Working Group developed the list with an activities-based frame of mind, recognizing that any ownership type and/or corporate structure could participate in these activities, including but not limited to PE owned insurers. The MWG members discussed detailed elements of the considerations and potential regulatory work, including explicit reference to the 2013 guidance added to the NAIC Financial Analysis Handbook for Form A reviews when a private equity owner was involved, and interested parties added useful comments to these during an exposure period. The MWG and FSTF adopted a final plan for addressing each of the 13 considerations, including many referrals to other NAIC committee groups.

The Financial Condition E Committee adopted this plan with no changes made during its virtual meeting on July 21, 2022. NAIC staff support drafted this referral letter to accomplish the actions captured in the adopted plan. It is unlikely any further modifications will occur to the adopted plan when it is considered for adoption by the full Plenary, but it is a possibility. Please begin work to address these referrals, recognizing the adoption by Plenary is still outstanding.

Each MWG consideration referred to your group is listed below. The summarized notes from the MWG regulator-only discussions follow the consideration in blue font and any interested party comments are also provided in purple font. Please consider these discussion points and comments in addition to your own discussion ideas when developing proposals to address the MWG consideration.

NAIC staff support for the MWG will follow the work your group performs and summarize your activities for reporting up to the FSTF. If you have any questions or need further direction, please contact Todd Sells (tsells@naic.org).

MWG Consideration Items Referred:

10. The material increases in privately structured securities (both by affiliated and non-affiliated asset managers), which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency. (The NAIC Capital Markets Bureau continues to monitor this and issue regular reports, but much of the work is complex and time-intensive with a lot of manual research required. The NAIC Securities Valuation Office will begin receiving private rating rationale reports in 2022; these will offer some transparency into these private securities.)
    a. LATF's exposed AG includes disclosure requirements for these risks as well as how the insurer is modeling the risks.
    b. SVO staff have proposed to VOSTF a blanks proposal to add market data fields (e.g., market yields) for private securities. If VOSTF approves, a referral will be made to the Blanks WG.

Regulator discussion results:

- Regulators focused on the need to assess whether the risks of these investments are adequately included in insurers' results and whether the insurer has the appropriate governance and controls for these investments. Regulators discussed the potential need for analysis and examination guidance on these qualifications.
- To assist regulators in identifying concerns in these investments, regulators expressed support for the VOSTF proposal to obtain market yields to allow a comparison with the NAIC Designation. Once such data is available, regulators ask NAIC staff to develop a tool or report to automate this type of initial screening. Also, regulators again recognized the SAPWG Schedule D revamp work will help in identifying other items for initial screening.
- The regulators discussed LATF's exposed AG, noting the Actuarial Memorandum disclosures that would be required for these privately structured securities along with the actuarial review work, and recognizing how those would be useful for analysts and examiners when reviewing these investments. Additionally, the Valuation and Analysis (E) Working Group would be able to serve as a resource for some of these insights for states without in house actuaries.
- As a result of the above discussions, regulators agreed to a referral to the Examination Oversight (E) Task Force to address the disclosures that will be available from LATF's exposed AG. They agreed to wait for any further work or referral until they have an opportunity to work with the results of the VOSTF proposal and the SAPWG Schedule D revamp project.
- *Since reserves are not intended to capture tail risk, refer this item to the NAIC RBC Investment Risk and Evaluation (E) Working Group and monitor the Working Group's progress. (Regulators adopted this recommendation from the RRC comment letter.)*

RRC Comments on "privately structured securities which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency."

- ♣ While the lack of available public data does present a significant issue and does mean there is in theory a lower degree of liquidity, we caution at being overly concerned about the private nature of such transactions.
    - Any highly structured transaction is going to lack liquidity.
    - The NAIC had at one time a disclosure for Structured Notes. This allowed regulators to see when that represented an excessive risk. We encourage the reinstitution of that disclosure.
- ♣ A potential consideration related to complex asset structures would be to incorporate this risk factor into the criteria for additional liquidity risk analysis outlined in the NAIC 2021 Liquidity Stress Test Framework (Framework). Considering the amount of effort spent on developing the Framework, it may be helpful to leverage its requirements for situations in which significant complex securities are used to back insurer liabilities.

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

Insurers are increasingly seeking the services of alternative asset managers with significant asset origination capabilities and private credit expertise to manage a portion of their assets, which provide a number of benefits to the insurer and their policyholders. Those benefits include:

- ♣ A natural alignment between the long-dated insurance liabilities and the long-term investment approach taken by alternative asset managers, including in the private credit space;
- ♣ Alternative asset managers have the ability to source, underwrite and execute private credit transactions that require skill sets, experience, and scale that many insurance companies do not possess in-house;
- ♣ Private equity and private credit firms also provide an opportunity for smaller and midsized insurers to access these asset classes, which historically have been the primary purview of large insurers that have the scale to afford in-house asset management functions that can originate these assets, making the industry more competitive to the ultimate benefit of policyholders;
- ♣ Engaging asset managers with differentiated capabilities can be more cost efficient than making significant investments in an internal asset management function. By availing themselves of these advantages, insurers can benefit from cost-effective sourcing and origination capabilities in attractive asset classes, resulting in enhanced long-term adequacy margins for policyholders, increased spread/earnings, and more competitive product pricing that inures to the benefit of policyholders;
- ♣ Asset-backed security default rates are substantially similar to corporate investment grade debt default rates while CLO default rates are substantially lower than corporate default rates; and

- The focus on private investments is belied by the fact that institutions with higher allocations to private investments have outperformed (with less volatility) those with less.