Draft date: 3/14/23

2023 Spring National Meeting
Louisville, Kentucky

RISK-BASED CAPITAL INVESTMENT RISK AND EVALUATION (E) WORKING GROUP
Thursday, March 23, 2023
8:00 – 9:00 a.m.
Ballroom B - Main Concourse Level - KY 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	Rachel Hemphill	Texas
Roy Eft	Indiana	Steve Drutz/Tim Hays	Washington
Carrie Mears/Kevin Clark	Iowa	Amy Malm	Wisconsin
Fred Andersen	Minnesota		

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

AGENDA

1. Consider Adoption of its Feb. 27, 2023; and Fall National Meeting Minutes —*Philip Barlow (DC)* Attachments A&B

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

3. Continue Discussion of Collateralized Loan Obligations—*Philip Barlow (DC)*

4. Discuss Residual Tranche Structural Change—*Philip Barlow (DC)* Attachment C

5. Discuss Factor and Next Steps—*Philip Barlow (DC)*

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

7. Adjournment

Draft: 3/17/23

Risk-Based Capital Investment Risk and Evaluation (E) Working Group
Virtual Meeting
February 27, 2023

The Risk-Based Capital Investment Risk and Evaluation (E) Working Group met Feb. 27, 2023. The following Working Group members participated: Philip Barlow, Chair (DC); Thomas Reedy (CA); Wanchin Chou (CT); Ray Spudeck (FL); Vincent Tsang (IL); Carrie Mears and Kevin Clark (IA); Fred Andersen (MN); William Leung (MO); Lindsay Crawford (NE); Bob Kasinow and Bill Carmello (NY); Dale Bruggeman and Tom Botsko (OH); Rachel Hemphill (TX); Tim Hays (WA); and Amy Malm (WI).

1. Discussed the American Academy of Actuaries' (Academy) Follow Up to Presentation on Collateralized Loan Obligations (CLOs)

Stephen Smith (American Academy of Actuaries—Academy), chair of the Academy's C1 Work Group, presented the Academy's letter (Attachment). He said the intersection of the collateralized loan obligations (CLOs) and RBC creates a unique challenge for purely modeling credit risk purposes. He said the Academy is looking for regulatory guidance on the statistical safety level in terms of how the risk should be measured. Historically, factors for bonds have been based on the 96th percentile of losses. The Academy suggested in their October report that a conditional tail expectation (CTE) type of measure would be more appropriate due to the cliff risk embedded in CLOs and the Academy is seeking regulator input. Smith said the Academy is also seeking input on where to set the statistical safety level as well as on the concept of RBC arbitrage. As the Academy previously indicated, he said structuring does not eliminate risks but changes the nature of the risk, especially among the tranches for a number of reasons.

Smith said the Academy's view is that the total C-1 requirement for adding up all the underlying loans inside of a CLO does not necessarily have to equal the sum of the capital charges on a vertical slicing of a CLO. The Academy is asking if regulators have a strong view on this and if so, the Academy is going to incorporate regulators' view into their work. Otherwise, the Academy would like to know what they can share to help inform the view. The Academy has expressed the view that the materiality is low enough that a short-term solution may not be needed so more time can be given to a longer-term solution. If regulators' judgement is different, the Academy would like to know what they can do to be supportive. Barlow said the first question is whether there is an urgency in updating the C-1 factors for CLOs. He said the Working Group is currently working on two projects and the first one is updating the C-1 factors for CLOs. He said he understands that the risk may not be sufficiently material right now overall but there may be some companies for which it is material so the Working Group wants to address that. He said the two projects are to get solutions for the CLOs and to get an interim solution to address residual tranches before a more long-term solution can be developed for structured assets. He said the Working Group would like the Academy's work group to do a diligent review of the CLOs and develop recommendations as quickly as they can, but this is separate from the short-term interim solution for the residual tranches.

Barlow said the Working Group is looking to the Academy to provide some recommendation on the statistical safety level. Because of the level of tail risk involved, he said he believes the Working Group would feel more comfortable with a CTE type measure. In terms of the time horizon, he said he believes the Working Group would benefit from the Academy's perspective. Carmello said he believes using CTE makes sense but expressed concern with just using historical information. He said he believes it is more appropriate for RBC to have some modeling of potential market situations that are worse than the historical experience. Ms. Mears agreed on using CTE as opposed to using percentile just because it was used for other types of investments as long as it does not introduce too much complexity. Tsang questioned whether it would be confusing to change the C-1 factor from the 96th percentile to the CTE measure. Barlow said RBC has percentile and CTE measures in various components and there are ways to determine consistency. Smith said the Academy would work on a reconciliation between the CTE and percentile measures to make them comparable.

With respect to the Academy's question on RBC arbitrage, Barlow said he believes this is more of a topic for the Capital Adequacy (E) Task Force because it impacts more than the asset side of the RBC. Mears and Botsko agreed. With respect to the C3 implications, Barlow said, once the structure for C1 is in place, this could be addressed if it is material enough.

With respect to whether active management within the CLO structure should be considered in developing C-1 factors, Barlow said the Working Group would look to the Academy for a recommendation. He said he believes assuming an active management adds a lot of complexity and no active management sounds more conservative. Smith said the first kind of active management is around credit selection and it would be more conservative not to model active management for this kind. He said the other kind of active management is that the manager makes active decisions especially in terms of whether it is extending and refinancing debt tranches or shifting risks around among the tranches. He said this gets a lot more complicated to model. Mears said implications of not including the active management need to be understood. Chou said he would support the more complicated study on the active management. Tsang expressed concern and said he is not sure whether it adds any value. Barlow said it appears there is agreement on being conservative on the first kind of active management and there is an interest in identifying how material the second kind of active management potentially could be. Smith said the Academy will take this feedback and do some work on the risks shifting between tranches of the active management.

2. Discussed Comment Letters

Paul Graham (American Council of Life Insurers—ACLI) presented the ACLI's comment letter (Attachment) and said the ACLI would like to have some analysis supporting the interim solution and is proposing one factor for now. He said the ACLI is proposing boundaries on the factor because it should not have more impact than completely non-admitting the assets. This is different for every company depending upon where their RBC level is. In addition, the ACLI is proposing sensitivity tests.

Debra Casey (Global Atlantic Financial Group), representing a group of companies, presented their comment letter (Attachment). She said they commended the Working Group for engaging the Academy to prepare the report on CLOs and agreed with the summary observations from that study. She said they do not understand the sense of urgency with the need for the interim solution but do the need to do something for structured securities. She agreed with the ACLI on sensitivity analysis that would provide regulators with more transparency as to the holdings and the impact on the RBC of CLOs versus other types of asset backed securities. She said the main point of their comment letter is that they believe there needs to be a data driven solution and support the model used for the update of the bond factors with an expert engaged along with engaging the industry to perform field testing. At least for CLOs, she said they believe there can be a streamlined process that can produce new factors or a new methodology that could be implemented at the same time as the new bond standards.

Christopher Halldorson (Prudential), representing a group of companies, presented their comment letter (Attachment). He said there have been several comments concerned about the arbitrary nature of an interim solution and the arbitrary charge of 30% should have already been recognized, which is based on the analysis of public equity losses under stress and there is no analysis to connect that to residual tranches of structured securities. He said the residual tranches of structured securities are highly leveraged to the underlying, typically high yield collateral, and that is not the same risk as holding S&P 500. He said they support an interim charge of at least 45%, which is the highest current factor for high beta equity holdings. He also said this is a fast-growing asset class and there are some material concentrations. They think a single charge that has some analysis supporting it, which is more than what currently exists, is a good first step and can lead to a more robust transparency.

Eric DuPont (Guardian Life) said he spoke for his company and partnered closely with Massachusetts Mutual Life Insurance Company on their comment letter (Attachment). He said they appreciate the thoughtful approach taken and they would suggest continuing that and finding a data driven solution. They think the sensitivity testing provides an opportunity to provide what-if scenarios. He said there is some concern about individual companies that may have high concentrations of risk and they believe what-if scenarios can identify those so regulators can address those particular companies rather than taking a broad brush that would apply to the entire market.

Barlow said he does not believe the charge from the Financial Condition (E) Committee can be addressed solely by sensitivity testing but said proposed approaches to sensitivity testing can be submitted. He said the original referral of three factors from the Valuation of Securities (E) Task Force can be simplified to one factor at least for the interim solution. Mears said it would be fine if the Working Group wants to move forward with a single factor for an interim solution.

Mears said 2022 reporting is the first time to have residuals reported separately and the definition of what should go in that category may need to be more explicit. She suggested the Working Group consider a referral to the Statutory Accounting Principles (E) Working Group to review that definition.

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

Draft: 1/9/23

Risk-Based Capital Investment Risk and Evaluation (E) Working Group
Tampa, Florida
December 14, 2022

The Risk-Based Capital Investment Risk and Evaluation (E) Working Group of the Capital Adequacy (E) Task Force met Dec. 14, 2022. The following Working Group members participated: Philip Barlow, Chair (DC); Thomas Reedy (CA); Wanchin Chou (CT); Robert Ridenour (FL); Carrie Mears and Mike Yanacheak (IA); Vincent Tsang and Bruce Sartain (IL); Ben Slutsker (MN); Debbie Doggett (MO); Justin Schrader (NE); Bob Kasinow and Bill Carmello (NY); Dale Bruggeman and Tom Botsko (OH); Rachel Hemphill (TX); Steve Drutz (WA); and Amy Malm (WI).

1. <u>Adopted its Summer National Meeting Minutes</u>

Botsko made a motion, seconded by Doggett, to adopt the Working Group's Aug. 11 minutes (*see NAIC Proceedings – Summer 2022, Capital Adequacy (E) Task Force, Attachment Seven*). The motion passed unanimously.

2. <u>Adopted its Working Agenda</u>

Chou made a motion, seconded by Drutz, to adopt the Working Group's working agenda (Attachment A). The motion passed unanimously.

3. <u>Exposed the Academy's Presentation on CLOs and an Interim Proposal to Address Residual Tranches</u>

Stephen Smith (American Academy of Actuaries—Academy), chair of the Academy's C1 Work Group, said the Academy is providing this update (Attachment B) at the request of the Working Group to explore collateralized loan obligations (CLOs) and their impact to capital in the life insurance industry. He said the Academy's work is continuing and that there are issues that are important that the Academy does not yet have answers for. While there are some conclusions in the Academy's presentation, Smith highlighted what he believes to be the two most important ones. He said the first is that, from an actuarial perspective, the Academy does not believe the bond factors are appropriate for CLOs. However, he said the second is that the exposure across the life industry, and at most individual companies, is small, so there is not a major risk to surplus or solvency. Therefore, the Academy does not believe there is an urgency to get this done immediately, sot there is time to determine factors that are appropriate. Smith presented the Academy's update beginning with some CLO basics, which included discussion of types of collateral, the typical capital structure at issue, and the CLO lifecycle.

With respect to the ratings shown for the different tranches in the structure and the Academy's position that the bond factors are not appropriate for CLOs, Barlow asked if the ratings for CLOs have the same meaning as they do for a bond. Smith said they do not in a precise sense. As part of the Academy's work, he said the Academy has spoken with the CLO teams at rating agencies, and the loss distribution could look different for a CLO than it would for a corporate bond, as well as differences in the probability of default and the loss given default.

Smith discussed the life insurance industry's exposure to CLOs, detailing the current holdings by rating, the holdings over time as a percentage of general account assets, anonymized examples of the largest holdings for individual companies, and with the Academy's observations on materiality. He then discussed key risk-based capital (RBC) concepts that were part of the Academy's work and how those concepts should be applied to CLOs. He discussed the statistical safety level, specifically detailing the risk measure and time horizon used for bonds and common stocks. He also noted other measures within the life RBC formula and contrasted these with questions as to what should be assumed for CLO debt and residual tranches. Smith discussed the concept of RBC arbitrage and the NAIC Investment Analysis Office's (IAO's) May 25, 2022, risk assessment of CLOs. He described the Academy's observations on risk equivalence through structuring, areas of disagreement with the "no RBC arbitrage" principle, and the Academy's observations on the broader application of that principle. Smith discussed residual tranches, the current RBC treatment, and the reporting changes effective for year-end 2022. He noted that the 30% factor was derived from a study on unaffiliated common stock and was not based on anything resembling the loss experience of a CLO residual tranche. He said the Academy also has not seen any quantitative analysis that would support a 75% or 100% factor, so there is work that needs to be done to get it right. Barlow said the intent is for what is done for residual tranches to be part of an interim solution with the ultimate goal to be an overall RBC methodology that the Working Group is comfortable with that includes more than just the residual tranches. Smith closed by presenting what the Academy believes are key questions for state insurance regulators, a summary of the Academy's observations, and the Academy's next steps.

The Working Group agreed to expose the Academy's presentation, along with an interim proposed structural change (Attachment C) to address residual tranches for year-end 2023, for a 45-day public comment period ending Jan. 27, 2023.

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

OTHER LONG-TERM ASSETS (CONTINUED)

		Annual Statement Source	(1) Book / Adjusted Carrying Value	(2) Unrated Items ‡	(3) RBC Subtotal †	(4) Factor	(5) RBC Requirement
	Schedule BA - Unaffiliated Common Stock						
(42)	Schedule BA Unaffiliated Common Stock-Public	AVR Equity Component Column 1 Line 65				X § =	
(43)	Schedule BA Unaffiliated Common Stock-Private	AVR Equity Component Column 1 Line 66				X 0.3000 =	
(44)	Total Schedule BA Unaffiliated Common Stock (pre-MODCO/Funds Withheld)	Line (42) + (43)					
(45)	Reduction in RBC for MODCO/Funds Withheld Reinsurance Ceded Agreements	Company Records (enter a pre-tax amount)					
(46)	Increase in RBC for MODCO/Funds Withheld Reinsurance Assumed Agreements	Company Records (enter a pre-tax amount)					
(47)	Total Schedule BA Unaffiliated Common Stock (including MODCO/Funds Withheld.)	Lines (44) - (45) + (46)					
	Schedule BA - All Other						
(48.1)	BA Affiliated Common Stock - Life with AVR	AVR Equity Component Column 1 Line 67					
(48.2)	BA Affiliated Common Stock - Certain Other	AVR Equity Component Column 1 Line 68					
(48.3)	Total Schedule BA Affiliated Common Stock - C-1o	Line (48.1) + (48.2)				X 0.3000 =	
(49.1)	BA Affiliated Common Stock - All Other	AVR Equity Component Column 1 Line 69					
(49.2)	Total Sch. BA Affiliated Common Stock - C-1cs	Line (49.1) ~~+ AVR Equity Component Column 1 Line 93~~				X 0.3000 =	
(50)	Schedule BA Collateral Loans	Schedule BA Part 1 Column 12 Line 2999999 + Line 3099999				X 0.0680 =	
(51)	**Total Residual Tranches or Insterests**	**AVR Equity Component Column 1 Line 93**				**X TBD =**	
(52.1)	NAIC 01 Working Capital Finance Notes	AVR Equity Component Column 1 Line 94				X 0.0050 =	
(52.2)	NAIC 02 Working Capital Finance Notes	AVR Equity Component Column 1 Line 95				X 0.0163 =	
(52.3)	Total Admitted Working Capital Finance Notes	**Line (52.1) + (52.2)**					
(53.1)	Other Schedule BA Assets	AVR Equity Component Column 1 Line 96					
(53.2)	Less NAIC 2 thru 6 Rated/Designated Surplus Notes and Capital Notes	Column (1) Lines (23) through (27) + Column (1) Lines (33) through (37)					
(53.3)	Net Other Schedule BA Assets	**Line (53.1) less (53.2)**				X 0.3000 =	
(54)	Total Schedule BA Assets C-1o (pre-MODCO/Funds Withheld)	Lines (11) + (21) + (31) + (41) + (48.3) + (50)+ **(52.3) + (53.3)**					
(55)	Reduction in RBC for MODCO/Funds Withheld Reinsurance Ceded Agreements	Company Records (enter a pre-tax amount)					
(56)	Increase in RBC for MODCO/Funds Withheld Reinsurance Assumed Agreements	Company Records (enter a pre-tax amount)					
(57)	Total Schedule BA Assets C-1o (including MODCO/Funds Withheld.)	Lines **(54) - (55) + (56)**					
(58)	Total Schedule BA Assets Excluding Mortgages and Real Estate	Line (47) + (49.2) **+ (51) + (57)**					

† Fixed income instruments and surplus notes designated by the NAIC Capital Markets and Investment Analysis Office or considered exempt from filing as specified in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* should be reported in Column (3).

‡ Column (2) is calculated as Column (1) less Column (3) for Lines (1) through (17). Column (2) equals Column (3) - Column (1) for Line **(53.3)**.

§ The factor for Schedule BA publicly traded common stock should equal 30 percent adjusted up or down by the weighted average beta for the Schedule BA publicly traded common stock portfolio subject to a minimum of 22.5 percent and a maximum of 45 percent in the same manner that the similar 15.8 percent factor for Schedule BA publicly traded common stock in the Asset Valuation Reserve (AVR) calculation is adjusted up or down. The rules for calculating the beta adjustment are set forth in the AVR section of the annual statement instructions.

Denotes items that must be manually entered on the filing software.

