

NAIC Spring 2023

National Meeting Update

Pg. 2 Statutory Accounting Principles (E) Working Group (SAPWG)

Dedicated to maintaining accounting principles and providing periodic updates to guidance as it develops. The SAPWG focuses on discussions that result in changes to the *Accounting Practices and Procedures (AP&P) Manual* and related SSAPs.

Pg. 6 Valuation of Securities (E) Task Force (VOSTF)

Dedicated to designations, valuations, and the Securities Valuations Office (SVO) filing process as outlined in the *Purposes and Procedures (P&P) Manual* of the NAIC Investment Analysis Office.

Pg. 9 Risk-Based Capital Investment Risk and Evaluation Working Group (RBCIREWG)

Dedicated to reviewing RBC investment framework for all business types.

Pg. 10 Capital Adequacy Task Force (CADTF)

Dedicated to evaluating refinements to capital requirements for insurers.

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The NAIC held its Spring 2023 National Meeting March 21–25 in Louisville, Kentucky. Clearwater’s insurance experts attended the meeting to track guidance as it was adopted and discussed. The following market insight paper is a summary of the NAIC’s updates pertinent to investment accounting and reporting.

Of note, the SAPWG adopted five items during the spring meeting, including an interest income disclosure update that adds requirements for aggregate deferred interest and cumulative amounts of paid-in-kind interest included in the current principal balance, effective for year-end 2023. They also adopted language to be added to SSAP No. 100R regarding the fair value measurement of restricted equity securities subject to contractual sale restrictions to be consistent with SAP.

The SAPWG also exposed revisions related to the principles-based bond definition project, and NAIC staff wants to know how the industry has amortized the residual tranches and assessed for OTTI as there are no contractual principal or interest payments.

The VOSTF discussed a proposed amendment to add instructions for structured equity and funds and heard feedback from both interested parties and SVO staff. SVO staff said structured equity and funds are sometimes called rated notes or feeder funds or investments with the insertion of an intervening entity. The underlying assets may not qualify as bonds or be eligible to receive a designation under the current NAIC regulatory guidance. This regulatory transformation enables the intervening entity issues or notes to receive a credit rating provider rating.

The task force also received a request for next steps for the collateralized loan obligation modeling project. An ad hoc working group will begin meeting in April with a first order of business to work on the prepay discount dynamic to demonstrate the quantitative impact of these proposals and tranche losses to regulators. It will allow the interested parties to tie out the model.

Read on for more details from the Spring National Meeting.

Statutory Accounting Principles Working Group

The Statutory Accounting Principles Working Group held a national meeting on March 22, 2023.

Adopted Item Effective December 31, 2023

Ref #2022-27: Interest Income Disclosure Update

This item adds additional disclosure requirements for aggregate deferred interest and cumulative amounts of paid-in-kind (PIK) interest included in the current principal balance, effective for year-end 2023, to SSAP No. 34, paragraph 7. NAIC staff emphasized this new agenda item is not contingent on the principles-based bond project and is pertinent to existing investments held.

SAPWG directed NAIC staff to submit a corresponding blanks proposal (2023-11 BWG) to the Blanks Working Group (BWG) for year-end 2023.

Adopted Items Effective Immediately

Ref #2022-15: SSAP No. 25 – Affiliate Reporting Clarification

This item was exposed at the NAIC 2022 fall national meeting with a comment deadline of February 10, 2023. No comments were received from the industry.

It adds clarifying language to SSAP No. 25, paragraph 5 that any invested asset held by a reporting entity, which is issued by an affiliated entity, or which includes the obligations of an affiliated entity, is an affiliated investment and should be reported on the “Parent, Subsidiaries and Affiliates” reporting lines in the investment schedules.

Ref #2022-16: ASU 2022-03 Fair Value Measurement of Restricted Equity Securities Subject to Contractual Sale Restrictions

This agenda item came from ASU 2022-03, which identifies two scenarios for restricted equity securities:

one where the restriction is based on the characteristic of the entity holding the equities, e.g., lock-up periods, and one where the restriction is the security characteristics, e.g., private placement. It was exposed in December 2022 and no comment was received.

It adds language to SSAP No. 100R to adopt ASU 2022-03 with modifications to be consistent with SAP. When the contractual sale restrictions are a characteristic of the investor holding the equity rather than a characteristic of the asset, such restrictions are not considered in measuring the fair value of an equity security. It does not recommend incorporating the new proposed GAAP disclosure requirements on sales restrictions, but restricted assets would be captured pursuant to SSAP No. 1 and subject to admittance considerations under SSAP No. 4. Restricted securities are generally considered to be admitted assets to the extent that they can be used to cover policyholder obligations under SSAP No. 4, 30R, 32R, and 48.

Ref #2017-33: Issue Paper No. 16X – Derivatives and Hedging (ASU 2017-12)

This issue paper was created for future reference. It is related to three previous authoritative accounting guidance adoptions (2018-30, 2021-20 & 2022-09), e.g., revisions to the documentation and assessment of hedge effectiveness, measurement method guidance for excluded components, and modified incorporation of the US GAAP portfolio layer method and the partial-term hedging method in SSAP No. 86 – Derivatives.

No comment was received during the exposure period.

Ref #2022-18: ASU 2022-04 Disclosure of Supplier Finance Program Obligations

Language was added to SSAP No. 105R – Working Capital Finance Investments rejecting ASU 2022-04, as this is for borrowers in these programs and not related to insurance investors that invest in these programs.

Exposed Item with Comment Deadline June 9, 2023

Ref #2022-19: Negative IMR (SSAP No. 7 – Interest Maintenance Reserve)

The SAPWG exposed INT 23-01T on April 10 via email. It proposes a limited-time, optional, INT to allow admittance of net negative (disallowed) IMR in the

general account up to 5% of adjusted capital and surplus for insurers with an RBC greater than 300%. Insurers with a 300% or lower RBC, are not allowed to admit net negative IMR. This INT doesn't apply to separate accounts. Negative IMR admitted is limited to IMR generated from losses incurred from the sales of bonds or other qualifying fixed-income investments that were measured at amortized cost prior to the sale, and the sales proceeds must be used to acquire bonds or other qualifying fixed-income investments that will be reported at amortized cost. Insurers utilizing this INT are required to disclose non-amortized impact to IMR from capital gains/losses from derivatives that were measured at fair value, gross/admitted/nonadmitted negative IMR, adjusted capital and surplus, and the percentage of adjusted capital and surplus for which the admitted negative IMR represents quarterly and annually.

The working group had regulator-only sessions with industry in January and February to review insurers' specific information. The ACLI said changes of fixed-income instruments from low yield to high yield will result in realized capital losses (i.e., negative IMR) in the current rising interest rate environment. Some hedging derivatives settlements can create negative IMR without an offset impact from a bond sale when they are utilized for pension risk transfers or hedging against risks on the liabilities. The current statutory accounting treatment of negative IMR (i.e., nonadmitted IMR asset) disincentivizes prudent investment and risk management and is not in the best interest of the policyholders. Insurers with net negative IMR are perceived as decreased financial strength through lower surplus and RBC ratios. The ACLI emphasized there is no change to the insurers' solvency, liquidity, or claims paying ability as long as the insurers reinvest in higher yielding bonds with the sale proceeds from the disposal of lower yielding bonds.

The SAPWG directed NAIC staff to draft the proposed change for long-term solution, provide updates on annual statement instructions for excessive withdrawals, and clarify the related bond gains/losses and non-effective hedge gains/losses are through asset valuation reserve (AVR) and not IMR, develop new accounting and reporting guidance for net negative IMR, and a disclosure requirement to ensure sales of bonds are reinvested in other bonds. Some working

group members suggest allowing negative IMR to be admitted up to 5% of surplus but have a downward adjustment required if the RBC ratio is below 300.

A referral will be sent to the LATF with a request to develop a template for reporting within asset adequacy testing (AAT), consider the actual amount of negative IMR that is admitted to be used in the AAT, consider cash flows within AAT and any liquidity stress test (LST), ensure excessive withdrawal considerations are consistent with actual data (sales of bonds due to excessive withdrawals should not go through the IMR process), and ensure any guardrails for assumptions in the AAT are reasonable and consistent with other aspects. Another referral will be sent to the Capital Adequacy Task Force (CADTF) with a request to consider eliminating any admitted net negative IMR from total adjusted capital (TAC) and perform sensitivity testing with and without negative IMR.

Ref #2019-21: Principles-Based Bond Definition

Revisions to SSAP No. 26R, 43R, and other SAPs were exposed during the NAIC 2022 fall national meeting. This includes a proposal to not allow ABS to be reported as short-term securities on Schedule DA or E Part 2 under SSAP No. 2R, and new guidance for those debts won't be qualified for bonds reporting under SSAP No. 21R.

Comments were received and a number of changes were made by the staff:

› SSAP No. 26R

- Adds a footnote to paragraph 6d that debt securities with nominal interest adjustments are not excluded from bond treatment as long as those adjustments adjust the total return from interest by less than 10%.
- Adds paragraph 47, which states the reporting entities shall not restate the prior year's information for comparison in the 2025 disclosure.

› SSAP No. 21R

- Debt securities captured in this scope shall be reported at the lower of amortized cost or fair value regardless of their NAIC designation. Changes in measurement to reflect a lower value or to reflect changes in fair value must be recorded as unrealized gains or losses under SSAP No. 21R, paragraph 24.

- Residual tranches are admitted only if the underlying assets qualify as admitted assets. They are nonadmitted if the debt security from a securitization is nonadmitted under SSAP No. 21R, paragraph 29.
- Recognize a realized loss, which is equal to the remaining amortized costs basis, upon identification of a probable OTTI for residual tranches, and subsequently report them with a zero book-adjusted carrying value. Any future cash flows received attributed to the residual tranche shall be reported as interest income.

NAIC staff wants to know how the industry has amortized the residual tranches and assessed for OTTI as there are no contractual principal or interest payments.

It also proposes to make the following changes on the Schedule BA reporting structure (Comment deadline June 30, 2023):

- › Combine existing categories "Non-Registered Private Funds with Underlying Fixed Income Assets" with "Joint Venture, Partnership or LLC with Underlying Assets"
- › Add the new reporting categories for debt securities that do not qualify as bonds due to no creditor relationship in substance, lack substantive credit enhancement, or solely due to a lack of meaningful cash flows.
- › Remove three categories: Oil and Gas Production, Transportation Equipment, and Mineral Rights.
- › For investments that have not been assigned an NAIC designation by the SVO but are rated by NRSRO, it is allowed but not required to report the NAIC designation derived from the NRSRO's ratings.
- › Collateral loans are backed by any form of collateral regardless of if the collateral is sufficient to fully cover the loan. Follow guidance in SSAP No. 21R to determine nonadmittance.

NAIC staff wants to know how the industry has amortized the residual tranches and assessed for OTTI as there are no contractual principal or interest payments.

Ref #2022-11: Collateral for Loans

This item was exposed in August 2022 and re-exposed in December 2022.

NAIC staff clarified that invested assets pledged as collateral for admitted collateral loans, must qualify as admitted invested assets. In their comments, interested parties said some collateral loans are backed by investments in joint ventures, partnerships, and LLCs. Audits are required under SSAP No. 97 and SSAP No. 48 for those investments held directly, and audit does not validate fair value of the investment, which is a core standard of collateral guidance. Interested parties propose adding a footnote to SSAP No. 21R, which specifies insurers are allowed to obtain a fair value assessment from an unrelated third party in place of an audit in order for a pledged collateral, which is a joint venture, partnership, or LLC, to qualify as an admitted asset.

The regulators are not comfortable with the third party's fair value assessment suggestion, and they prefer the audited financial statements. NAIC staff recommends adding additional clarifying language to SSAP No. 21

- › Paragraph 4b – The proportionate audited equity valuation shall be used for the adequacy of pledged collateral that is joint ventures, partnerships, and LLCs. Any excess of collateral loan over the pledged collateral shall be nonadmitted.
- › Footnote 2 – Audited financial statements on a consistent annual basis are always required in accordance with SSAP No. 48 and/or SSAP No. 97 if the pledged collateral is joint venture, partnership, LLC, and/or subsidiary, controlled, and affiliated.

Ref #2023-02: SSAP No. 43R – CLO Financial Modeling

To reflect the guidance adopted by the VOSTF for the SVO *Purposes and Procedures (P&P) Manual* in February 2023, this item proposes adding the CLOs to the financial modeling guidance (i.e., SSAP No. 43R, paragraph 27 & 28) and to clarify that CLOs are not captured as legacy securities. It means no price points will be provided for the CLOs which were issued prior to 1/1/2013.

Ref #2023-05: ASU 2022-06, Reference Rate Reform (Topic 848), Deferral of the Sunset Date of Topic 848

This item proposes revising INT 20-01 to include the revised sunset date of December 31, 2024. The guidance in ASU 2022-06 only acts to defer the sunset date of Topic 848 from December 31, 2022, to December 31, 2024, after which entities will no longer be permitted to apply the relief (e.g., change the reference rate and other critical terms related to reference rate reform without remeasurement of the contract or dedesignation of the hedging relationship) from the prior ASUs 2020-04 and 2021-01.

Ref #2022-12: Review of INT 03-02 Modification to an Existing Intercompany Pooling Arrangement

This item was exposed in August 2022 and re-exposed in December 2022. A few comments were received.

One of the comment letters said the fair value of most of the bonds is below amortized cost (book value) in the current rising interest rate environment. The INT allows a bond with a fair value of \$85 to be used to settle an intercompany reinsurance pooling obligation of \$100. The current proposal will turn an unrealized loss position (15) into realized loss. If the bond was in an unrealized gain position, realized gains would be recorded and result in an initial gain in surplus. It will require the intercompany pooling reinsurance to be accounted for as retroactive reinsurance. Interested parties believe the current INT treats the transfer of bonds consistently (i.e., non-economic) with the transfer of liabilities and does not need any change.

NAIC staff said their intent of nullifying INT 03-02 is not to take something that is needed away and asked the industry if they should adjust SSAP No. 62R – *Property and Casualty Reinsurance* instead. Interested parties said they have some suggestions for SSAP No. 63 – *Underwriting Pools* instead of the INT.

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Exposed Items with Comment Deadline May 5, 2023

Ref #2023-11EP: Editorial Update

This item proposes replacing intrinsic value with volatility value in SSAP No. 86R, paragraph 43.a.ii. This change was proposed by industry to clarify the disclosure category for the excluded component to the BWG (2022-17BWG).

Other Items

Ref #2022-14: New Market Tax Credits / Tax Equity Investments

This item was exposed in fall 2022. It addresses new market and tax credit accounting including amortization, admittance, and impairment provisions. The working group received detailed comments from the interested parties — one comment suggests reconsidering prior guidance that have both amortization and interest income reported as the same line item on the income statement similar to what is required under US GAAP. Another comment suggests this type of investment be reported as a bond on Schedule D instead of Schedule BA, if it is in the form of debt instead of equity. Regulators said it should not be reported on Schedule D as they view them as BA assets.

The working group directed NAIC staff to incorporate final FASB guidance (EITF 21-A, Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method) on tax equity investments and industry feedback to draft revised accounting guidance for all qualifying tax equity investments and a corresponding issue paper for both SSAP No. 93 – *Low-Income Housing Tax Credit (LIHTC) Property Investments* and SSAP No. 94R – *Transferable and Non-Transferable State Tax Credits*.

Referrals will be sent to both BWG and CADTF as Schedule BA, AVR, and RBC reporting lines only reference LIHTC.

NAIC Accounting Practices and Procedures Manual

The interested parties sent a letter requesting the NAIC make available for purchase an *AP&P Manual* with an effective search capability and print functionality, preferably a licensed pdf version of the *AP&P Manual* on January 9, 2023. According to the interested parties,

the current BookShelf Online Subscription *AP&P Manual* does not provide an effective search capability or print functionality.

The NAIC responded on February 6, 2023, that a copyrighted pdf will be made available for the 2023 *AP&P Manual* at no additional cost for those who purchase a subscription to the manual. The NAIC will find an amicable, long-term solution for the 2024 *AP&P Manual* that will result in ease of access for industry users. In the interim, the users can get immediate access to newly adopted accounting guidance in pdf format, on the SAPWG website for free, and those documents will be available for one year.

Update on International Activity – IAIS Accounting and Auditing Working Group (AAWG)

NAIC staff were asked to inform the working group of their involvement in international activities. Julie Gann, Assistant Director – Solvency Policy, has been on the AAWG for a while, and the current focus is on the implementation of IFRS 17 and updates of other core insurance principles, e.g., ICP 14 – Valuation and ICP 17 – Capital Adequacy. It is expected the public exposure of these two core insurance principles will happen this July.

Valuation of Securities (E) Task Force

The Valuation of Securities Task Force held a national meeting on March 23, 2023.

Exposed Items with Comment Deadline of April 10, 2023

Proposed Update to the Notice of Credit Deterioration for the List of Qualified U.S. Financial Institutions (QUSFI)

This item proposes changes to the SVO *P&P Manual, Part Two paragraph 135* to allow the SVO to remove a financial institution from the Qualified U.S. Financial Institutions (QUSFI) List once the institution is closed by and/or placed in receivership or conservatorship, or notice is given of such action by their primary regulator(s). The reasons for this proposal are the recent bank incidents, in which both Silicon Valley Bank and Signature Bank were not downgraded below the minimum permitted ratings of BBB-/Baa3 prior to

receivership, and the most recent financial statements did not reflect sufficient financial weaknesses to warrant adding those financial institutions to the QUSFI Watch List.

The QUSFI List indicates the financial institutions eligible to issue letters of credit pursuant to NAIC Credit for Reinsurance Model Law #785. The letter of credit can be used to reduce the insurer's liability.

SVO staff recommended a short exposure period of 15 days followed by an email vote with a simultaneous referral to the Reinsurance Task Force.

Discussed Items

Proposed Amendment to Add Instructions for Structured Equity and Funds

This proposal was exposed for a 60-day public comment period ending February 13. A referral was sent to the Capital Adequacy Task Force, Life Actuarial Task Force, and RBCIREWG on February 3, 2023.

SVO staff said structured equity and funds are sometimes called rated notes or feeder funds or investments with the insertion of an intervening entity. The underlying assets may not qualify as bonds or be eligible to receive a designation under the current NAIC regulatory guidance. This regulatory transformation enables the intervening entity issues or notes to receive a credit rating provider rating. The notes are typically backed by equity or fund investments, even though some of them may have underlying bonds or loans. This type of structure could easily be backed by any assets, e.g., affiliates, non-admitted assets, real estate, mortgage loans, unrated loans or any asset types that are not eligible for filing exemption.

Staff said many of the transactions would qualify as bonds according to the proposed principles-based bond definition while others likely would not qualify.

Staff said many of the transactions would qualify as bonds according to the proposed principles-based bond definition while others likely would not qualify. This type of investment often circumvents the statutory accounting and RBC guidance.

The VOSTF received three comment letters from the interested parties. The SVO provided the following feedback toward some of those comments:

- › One interested party said this structure was developed to be anti-arbitrage, which means it intended to allow insurance companies to access fund investments with the capital charge that puts insurance companies on a level playing field with other entities (e.g., pension funds, banks and other non-insurance investors) that are subject to different regulatory regimes. SVO staff said this type of investment has the potential to undermine the NAIC regulatory framework. They are aware of at least one insurer using this structure to transfer their CLO combo notes to a principal protected security, which is explicitly made ineligible for filing exemption by the SVO *P&P Manual*.
- › SVO staff are sympathetic that the non-life insurers did not get the RBC benefit that's afforded to life insurers only for private fund investments on Schedule BA. They agree that a fund investment can be more operationally efficient, particularly for small insurers, than owning the underlying investments directly. They encourage insurers to address those treatment issues with the appropriate regulatory group instead of creating alternate investment structures when they do not like how an asset is treated within NAIC guidance for RBC or investment classification.
- › One interested party said this amendment proposal should wait for the SAPWG to finish its principles-based bond definition project, and the RBCIREWG to finish its RBC factors for residual tranches. SVO staff said each regulatory group has its own unique area of responsibility and expertise that ultimately creates the overall NAIC regulatory framework. Thus, this amendment or any VOSTF action isn't dependent on the completion of other regulatory groups' projects.
- › One interested party requested full transparency into the methodologies the SVO would use when assessing the structured equity and fund investment. SVO staff said they are authorized by the VOSTF to use generally accepted techniques or methodologies pursuant to the SVO *P&P Manual*, Part One paragraph 41. As this type of structure is a highly bespoke transaction and the types of underlying

investments can vary wildly, it will require the SVO to apply different approaches and methodologies based on the structure that it is reviewing. It is not possible to produce a generic standardized methodology.

- › One interested party said the SVO should already have sufficient transparency into the structured equity and fund transactions from the private rating letter rationale reports. The SVO said those reports did not contain sufficient information to fully analyze the transactions or the underlying investments, and the VOSTF hasn't authorized the SVO to act on any rationale reports when the SVO disagrees with the private letter ratings. The SVO emphasizes the use of credit ratings is one component of the services it provides regulators and is concerned for the limited resources of the SVO.
- › SVO staff recommended the VOSTF add a definition of structured equity and funds and remove them from the filing exemption process, because the FE process does not adequately serve the NAIC regulatory objectives for these investments.
- › An interested party said using WARF methodology is not appropriate for waterfall structures, and the unrated underlying debt securities get 5.B, which will result in a higher RBC charge than what it should be. They also expressed concern for the scope of this type of structure and if it includes all equity backed securities, of which there are quite a substantial number.
- › Another interested party said feeder fund structures serve important purposes, e.g. operational efficiency, allowing insurers to gain exposure to certain asset classes, level the playing field across smaller insurers. They said there may be limited situations where potential SVO reviews may be necessary.

The VOSTF sent a referral to the SAPWG requesting it to consider the definition of structured equity and funds in its residual guidance. The VOSTF directed staff to document the current process of how investments within the private letter rating (PLR) population are reviewed, PLR ratings are challenged by the SVO, and the communication with the impacted insurers.

Next Steps for the Collateralized Loan Obligation (CLO) Modeling Project

Eric Kolchinsky, Director of the Structured Securities Group, requested the ad hoc working group start meeting in early April because some interested parties said it is hard to provide feedback on the SVO's proposed methodology without seeing the whole suite of assumptions. The group's first order of business will be to work on the prepay discount dynamic to demonstrate the quantitative impact of these proposals and tranche losses. It will allow the interested parties to tie out the model.

The main goal of this ad-hoc group is to demonstrate the effects of prepay discount purchases to regulators. These meetings will allow the group to propose scenarios, tie out the cash flows and ensure methodology is adequately specified in the group's documents. The purpose of the group is to resolve and clarify any technical and modeling issues. All regulatory policy discussions will be limited and brought back to the task force. Kolchinsky asked the participants to think about the deals (e.g. CLO with bonds bucket, CLO with a very large CCC-rated loans bucket) that are commonly held by insurance companies, to use for modeling.

Proposed Questions for NAIC Credit Rating Providers (CRPs)

Carrie Mears, the Chair of the VOSTF, said they had a small ad hoc group last year go through some of the rating usage concerns. That group is no longer meeting because they are working directly with the CRPs. To better support the credit assessment processes dependent upon credit ratings, the VOSTF is planning to have the CRPs submit their answers to a series of questions in writing within 30-days. Then, they will have a private meeting with the task force members and NAIC staff to discuss further. She encouraged the interested parties to send their comments to the VOSTF, and the final list of questions will be published before scheduled meetings with the CRPs.

Annual Report from the Securities Valuation Office (SVO) on Year-End Carry-Over Filings

Charles Therriault, Director of the SVO, said the SVO reviewed about 13,000 filings. Of that number, 27% were initial filings, and 71% were annual filings. He said the

carry-over rate has increased from 6.7% (2021) to 9.2% (2022) due to being short staffed at year-end. An overall carry-over rate below 10% is typically manageable for the SVO. The industries for the securities filings are electric, gas, and sanitary services (16%), real estate (9%), and holding and other investment offices (4%). Due to the rapid growth of privately rated securities, the SVO received 2,850 PLR in 2019, 4,231 in 2020, 5,147 in 2021, and 6,792 in 2022. Because many PLR securities are being self-reported without the required reporting in the General Interrogatories and PLGI administrative symbol, the SVO reminds insurers to follow the reporting instructions.

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Risk-Based Capital Investment Risk and Evaluation Working Group

The Risk-Based Capital Investment Risk and Evaluation Working Group held a national meeting on March 23, 2023.

Continue Discussion of CLOs

As part of the ongoing discussion around the financial modeling of collateralized loan obligations (CLO), the American Academy of Actuaries' (Academy) C1 working group presented the latest CLO updates to the RBCIREWG in February and asked for guidance from regulators. The C1 working group is focused on a couple of main priorities, including a hypothetical model specifications document that is different from how CLOs are being modeled today. They want to build up a set of specifications, then hire someone to build the model.

As the group became aware of different definitions for RBC arbitrage among the regulators and interested parties, they are currently documenting the concept of RBC arbitrage, which is central to the CLO and feeder funds discussion.

Residual Tranche Structural Change

Philip Barlow, the chair of the RBCIREWG, said the charge they got from the Financial Condition Committee is to look at the residual tranches for all structured assets and not limited to CLOs. He emphasized that this structural change is intended to be an interim solution, because this asset type may not have enough volume to warrant developing a methodology for them.

Both Kevin Clark, the vice chair of the SAPWG, and Carrie Mears, the chair of the VOSTF, recommend waiting to see the population of residual tranches from the 2022 annual statements and see if the issue is pressing enough for an interim solution. The rest of the working group members disagreed with them and believe there is urgency to adopt the interim solution for this year-end. There are so many different structures out there that insurers can buy, which is concerning from a solvency perspective. One of the regulators recommends having a charge more than a common stock charge to make sure insurers know that the residual tranches are not like common stocks.

Kevin Clark said there is currently some ambiguity in the statutory accounting guidance of what constitutes a residual tranche, e.g., it is not currently clear if the securitizations held in the form of a LP should be recorded as LP investments under SSAP No. 48 or residual tranches under SSAP No. 21. There will be some continued inconsistency in reporting until the definition of residual tranches is further refined. He also pointed out that a flat RBC charge for residual tranches may not be appropriate, because the diversity of the residual tranche has an inverse relationship to the actual risk.

Carrie Mears said the residual tranches are very likely underreported for 2022-year end. The VOSTF will send a referral to the SAPWG for further refinement on the definition of residual tranches.

A regulator-only meeting will be held in a couple weeks to look at the data that came in from the annual statements.

Discuss Factor and Next Steps

The consensus from prior working group meetings was one single RBC factor for residual tranches for 2023-year end. Regarding the ACLI's proposal about adding

residuals to the sensitivity tests (LR038 & LR039), the working group's chair said the proposed changes in the sensitivity tests would not necessarily be a substitute for what the working group was asked to do, but they can be used by the regulators as an additional tool.

The insurance group said at least a 45% RBC charge would be an appropriate interim factor to adopt, because the estimate for possible losses, especially considering the tail risk scenarios, could be 65% or higher by using the historical data which is available on corporate credit in order to model CLOs.

They agreed the CLO modeling approach is a much better way to get to the real risk associated with the CLO tranches than using the historical performance data, which is very limited and inadequate for determining the right RBC factors for the CLOs. The modeling approach will use the much more robust historical data with regards to corporate credit performance in order to model the potential losses for CLO tranches, which are sort-of derivatives of that corporate credit. It will achieve parity in terms of having a similar RBC for similar risks. It will eliminate RBC arbitrage — a much lower RBC for the corporate loans that back a CLO. It is key to map the CLO tranches to the correct level of NAIC designation and RBC.

Referrals Received

The RBCIREWG received two referrals from the VOSTF (Details of the referrals can be found [here](#)):

- › Proposed SVO *P&P Manual* amendment to define and add guidance for structured equity and funds: This is for information purposes only and no action is required by both the CADTF and the RBCIREWG
- › Additional Market and Analytical Information for Bond Investments: Requires a response from both the CADTF and the RBCIREWG by May 15, 2023.

Capital Adequacy Task Force

The Capital Adequacy Task Force held a national meeting on March 23, 2023.

Adopted Item with Effective Date of December 31, 2023

Proposal 2022-09-CA – Revised Affiliated Investments Structure and Instructions

This adopted item modifies the reporting structure and instructions for the following RBC reports:

- › Life – LR030-LR031, LR042-LR044 (Details [see here](#))
- › P&C – PR003-PR005, PR007, PR029-PR032 (Details [see here](#))
- › Health – XR002-XR004, XR010, XR024-XR026 (Details [see here](#))

The task force received one comment letter from the ACLI in support of this proposed change during the 60-day comment period last year. Referrals were sent to the SAPWG and BWG, but no comments were received from these two groups.

Proposal 2022-15-H – Renumber XR008

The task force adopted this item, also adopted by the HRBCWG on March 21, 2023, which renumbers the lines on page XR008 – Miscellaneous Fixed Income Assets of the Health RBC formula for easier updates in the future.

Other Items

Discussion of fallout and possible implications from the recent turmoil in the banking sector.

The task force heard from Edward Toy of Risk & Regulatory Consulting about the evolving situation within the banking sector and what implications that could have on insurers following recent challenges within the sector.

Questions still remain about potential underlying issues that are not yet known. Toy said this is still an evolving situation.

Interest rates have risen since 2022, with an increase of between 250 and 400 basis points and that has a substantial impact on valuations. This affects not only bonds, but insurance companies that have assets with

longer duration. A rise of 300 to 400 basis points means that those long duration bonds lose up to 45-50% of their fair market value.

The other issue is concentration risk on the liability side, which will trigger the need to look more closely at the asset side. Issues could arise with the potential change in banking regulations and what implications that would have on the market and on the invested assets held by insurance companies.

Other than bonds, the consultant believes the next asset type that people need to pay attention to is commercial real estate (CRE), which has already been taking a hit since the end of last year. Regional banks represent

about 65% of the funding for CRE developers. Interest rate hikes affect the ongoing valuation of CRE, and it increases the risk of exposure for commercial mortgage loans and residential mortgage loans.

They also discussed recent action by the Fed to raise the interest rate by 25 basis points to combat inflation, in the midst of banking sector challenges. Another concern is idiosyncratic volatility that means different investment markets and different industry sectors started to act in different ways. It potentially created problems for banks. There were material weaknesses in their risk monitoring and risk management systems but their earnings looked fine.

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