

NAIC 2023 Summer National Meeting Highlights

August 25, 2023

The National Association of Insurance Commissioners (the “NAIC”) held its 2023 Summer National Meeting (the “Meeting”) from August 12–16, 2023, in Seattle, Washington. Debevoise attorneys attended many of the conference sessions in person or virtually, and in this update, we highlight meeting developments of particular interest to our insurance industry clients, colleagues and friends.

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Statutory Accounting and Risk-Based Capital

RBC Framework for Structured Securities

Following its adoption of a 45% sensitivity test for year-end 2023 financial reporting and an “interim” 45% risk-based capital (“RBC”) charge for year-end 2024 financial reporting applicable to the residual tranches of asset-backed securities or structured securities on June 14, 2023, the **Risk-Based Capital Investment Risk and Evaluation (E) Working Group** met on August 13, 2023 to hear a presentation from the American Academy of Actuaries (the “AAA”) on the AAA’s principles for structured securities RBC, including (1) developing a process to determine when an asset class needs to be modelled and whether securities within an asset class need to be modelled individually to determine RBC charges and (2) “candidate-principles” for consideration by the Working Group.

The AAA and Working Group members discussed the need for different RBC charges for asset-backed securities to the extent the risk profile of the assets are different from the risk profile for corporate bonds. The AAA referenced its December 2022 report to the Working Group, where it recommended adopting a different risk measure for collateralized loan obligations (“CLOs”) and potentially other structured securities using a Conditional Tail Expectation (“CTE”) as better capturing tail risk inherent in CLOs. The AAA asked the Working Group to consider whether to incorporate CTE into the potential framework for developing new RBC charges for structured securities, while maintaining consistent risk measures across asset classes.

The AAA also shared a chart describing the asset classes with the greatest potential for RBC arbitrage, noting that RBC arbitrage is most significant when the underlying collateral has an explicit C-1 RBC factor (CLOs, residential mortgage-backed securities, commercial mortgage-backed securities and collateralized fund obligations (“CFOs”)), with tranching structures more likely to produce RBC arbitrage than pass-through structures.

The Working Group will be meeting further with the AAA to raise additional questions, provide comments and agree on principles for the AAA to use in further developing a proposal for exposure and public comment. We will be continuing to follow this project as it develops and focusing in particular on the potential changes to the RBC framework for structured securities.

In parallel with changes to RBC charges for residual tranches adopted by the **Risk-Based Capital Investment Risk and Evaluation (E) Working Group**, the **Statutory Accounting Principles (E) Working Group** exposed revisions to Statement of Statutory Accounting Principles (“SSAP”) 48 – Joint Ventures, Partnerships and Limited Liability Companies – and related statutory financial statement blanks for Schedule BA concerning the reporting of investment structures that represent residual interests or a residual security tranche (a first-loss tranche) of structured securities. The shortened exposure deadline for comments of September 12, 2023 is intended by the Working Group to enable adoption of the proposal by the end of 2023 for use in 2023 year-end financial reporting. Residual tranches are expected to receive a 30% capital charge and a 45% sensitivity stress test for year-end 2023 financial reporting, and a 45% capital charge for 2024 financial reporting.

Principles-Based Bond Definition

After four years in development, the **Statutory Accounting Principles (E) Working Group** adopted revisions to SSAP 26R – Bonds – and SSAP 43R – Asset-Backed Securities – and other impacted SSAPs codifying its “principles-based bond definition” for determining when an investment can be reported as a “bond” under statutory

accounting and reported on Schedule D-1 of an insurance company's statutory financial statements. The adoption is effective as of January 1, 2025.

The new principles-based bond definition has implications for structured security investments (now labelled as asset-backed securities or ABS), including CFOs and rated-feeder vehicles, and the elements that must be met for reporting such an investment as a bond. As noted in prior updates, Statutory Issue Paper No. 1XX states that there will be a rebuttable presumption that a debt instrument collateralized by equity interests will not represent "a creditor relationship in substance," but that this presumption can be rebutted if "the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer."

The Working Group re-exposed for additional comment from industry stakeholders until September 12, 2023 proposed revisions to SSAP 21R – Other Admitted Assets – reflecting additional guidance for debt investments that do not qualify as bonds and the principles-based bond issue paper that provides additional guidance for satisfying the criteria for reporting debt investments as a bond.

NAIC Designations and SVO Filing Exempt Process

The **Valuation of Securities (E) Task Force** discussed two proposals that implicate potential RBC charges applied to insurance company assets.

Updates to the Definition of NAIC Designation

The first proposal concerns a proposed amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office to update the definition of an NAIC designation in order to clarify the purpose of and the risks addressed by NAIC designations, which are to reflect the likelihood of timely and full payment of principal and interest payments and the probability of principal and interest payment default. Prior to the 2023 Summer National Meeting, the NAIC Securities Valuation Office (the "SVO") met with industry members on July 28, 2023 to discuss additional clarifications and simplifications of the definition for the Task Force to consider in the future.

Industry commenters agreed that loss-given default should be included in an NAIC designation in certain situations and indicated that there was confusion among industry members as to how and whether tail risk should also be included in an NAIC designation, but proposed that different asset classes should be treated consistently if tail risk is considered. NAIC staff plans to incorporate updates into a minimally revised amendment for consideration by the Task Force, including language intended to ensure consistent treatment of tail risk across asset classes.

SVO Discretion Concerning “Filing Exempt” Investments

The second proposal concerns a proposed amendment that would authorize the SVO, in cases where an NAIC designation resulting from a credit rating provider (“CRP”) rating “does not provide a reasonable assessment of risk for regulatory purposes” (i.e., where an investment’s CRP rating differs by three or more notches from the SVO’s assessed designation), to challenge and override the NAIC designation assigned through the filing exemption process derived from a CRP and assign a different NAIC designation. Where an investment’s filing-exempt status is contested, the proposal would provide notice to the applicable insurer of a 120-day period in which the insurer may appeal the challenge. Under the proposal, appeals would be resolved in regulator-to-regulator meetings of the Task Force, at which the SVO would present the reason for removal of the security from the filing-exempt process.

Industry comments expressed grave concerns with the proposal on a number of fronts, including as to transparency within the decision-making process, the capability of the SVO to assess securities with rigor commensurate with CRP measurements but with incomplete information, and the self-contained nature of the contest and appeal proceedings. Industry commenters further cited issues raised by the other regulators from the **Lease-Backed Securities (E) Working Group** that the proposed grant of discretion to the SVO office is already having a significant effect on structured securities market activity.

The SVO emphasized that its intent was not to displace CRPs and explained that transparency is not a feature of the decision-making process for ratings by their nature given the private information regarding securities that is involved, though it could prepare a general summary of the reason for removal of a security from the filing-exempt process. The SVO also explained that it intends to utilize the same methodologies as large, nationally recognized statistical rating organizations and that no decisions, including as to appeals, would be made abruptly. Finally, Working Group members noted that the NAIC would continue to refine initial reporting processes and involve third-party evaluators in its decision-making apparatus. As activity in the structured securities markets among insurers continues to slow down given regulatory capital uncertainty generated by the proposal, industry participants urged further consideration of these concerns, which certain of the Working Group members agreed should be seriously considered, including at least two regulators proposing that the ultimate decision-maker for challenged NAIC designations should be the domestic state regulator of the impacted insurance company.

Financial Condition (E) Committee

Given the numerous proposals at various NAIC working groups pertaining to insurance company investment reporting and RBC, the **Financial Condition (E) Committee**

considered during the Meeting a proposal concerning a “Framework for Regulation of Insurer Investments – A Holistic Review” (the “Framework”), which touched on many of the topics discussed in this update, including the SVO’s proposal to clarify the definition of NAIC designations, the SVO’s discretion to reconsider NAIC designations for investments, and the **Risk-Based Capital Investment Risk and Evaluation (E) Working Group**’s efforts to develop new RBC methodologies for CLOs and other structured securities. The Committee exposed the Framework for public comment until October 2, 2023 and emphasized that while the Framework and the work of the SVO and the Working Group will require further refinement, they collectively mark an important step forward in the effort to modernize the regulation of insurer investments.

Collateral Loans

The **Statutory Accounting Principles (E) Working Group** discussed revisions to SSAP 21R – Other Admitted Assets – that had been re-exposed at the 2023 Spring National Meeting. These revisions clarified guidance regarding collateral loans backed by equity investments reported under SSAP 48 – Joint Ventures, Partnerships and Limited Liability Companies – providing that audited book value must be used to support the value of collateral with respect to these investments in order for collateral loans backed by such investments to be considered admitted assets (discussed further above).

Interested parties generally supported the proposed changes, but one interested party requested an accounting policy election to be implemented allowing for the use of fair value to measure the collateral, noting that collateral is typically measured at fair value, and that many SSAP 48 and SSAP 97 underlying collateral investments would likely be considered to be investment companies, which hold assets at fair value and generate a net asset value at fair value, such that audited equity and fair value are equivalent. While regulators expressed little interest in embracing optionality for these valuations, preferring consistent reporting by insurance companies, the Working Group agreed to extend the exposure period until September 12, 2023 to allow the industry time to develop a consensus around an approach to the valuation of collateral for these loans.

Negative Interest Maintenance Reserve

After continuous discussion between regulators and industry participants throughout the spring and summer, the **Statutory Accounting Principles (E) Working Group** unanimously adopted a previously exposed INT 23-01T, an interpretation of statutory accounting principles as an interim solution to allow each insurer to admit net negative interest maintenance reserve (“IMR”) up to 10% of such insurer’s adjusted capital and surplus, subject to completion by the reporting insurer of a new reporting entity attestation. The adopted interim rule incorporates revisions permitting insurers with an RBC greater than 300% (after adjustment to remove admitted positive goodwill,

electronic data equipment and operating system software, deferred tax assets and admitted IMR) to utilize the limited admittance of net negative IMR.

Industry groups supported both the adoption of the interim rule and the Working Group's continued work toward a permanent solution. The Working Group noted that the interpretation does not incorporate any primary reliance on asset adequacy testing, which will continue to use IMR for admitted assets. The interim rule is effective through December 31, 2025 or until nullified or extended by the Working Group. An ad hoc subgroup of the Working Group is being formed in order to prepare recommendations for a long-term solution to this issue.

The **Financial Condition (E) Committee** also adopted a short-term Interpretation 23-01: Net Negative (Disallowed IMR) that will remain in effect through year-end 2025 and reflects (i) the requirement for RBC to be over 300% after an adjustment to total adjusted capital with respect to soft assets and (ii) an allowance to admit up to 10% of the adjusted capital surplus.

Asset Adequacy—Life Insurers

The joint meeting of the **Financial Stability (E) Task Force** and the **Macroprudential (E) Working Group** heard an update on NAIC Actuarial Guideline LII ("AG 53") and its supplemental requirements adopted by the NAIC last year effective for year-end 2022. The goal of AG 53 is to help ensure the claims-paying ability of life insurers. The guidelines are intended to lessen the risks of assets being understated and creating the appearance of inadequate reserves. Under the guidelines, appointed actuaries for non-exempted life insurers are required to make certain disclosures on asset reporting reserves. The Working Group indicated it had 246 filings from since April 2023. The Working Group has prioritized the highest risk areas to better identify issues, including (1) net yield assumptions (particularly aggressive assumptions in respect of complex assets), (2) reinsurer collectability (the Working Group will be contacting 20–25 insurers requesting that they describe certain reinsurance treaties and how they evaluate counterparty risk) and (3) determining the fair market of internally valued assets.

Data, Privacy and Artificial Intelligence

The **Big Data and Artificial Intelligence (H) Working Group** received an update regarding the artificial intelligence/machine learning ("AI/ML") survey of homeowners insurance market participants in ten states. According to the Working Group, approximately 70% of reporting companies participating in the survey currently use, plan to use or intended to explore the use of, AI/ML. This result follows an approximately 88% positive response rate from a recent auto insurance survey as

reported at the Spring 2023 National Meeting. Following this survey, the Working Group intends to collect further data on usage, data elements, governance frameworks, consumer data and third-party frameworks, and to evaluate third-party concentration.

The **Privacy Protections (H) Working Group** received and discussed comments on Version 1.2 of the new Consumer Privacy Protections Model Law (#674), which was exposed on July 11, 2023 for a public comment period that ended on July 28. Due to the number of comments and one-on-one call requests received last month from interested parties, the Working Group determined that more time is necessary to engage the public and indicated that it would request an extension from the **Innovation, Cybersecurity, and Technology Committee** to further develop the draft Model Law later this year.

Notable comments on the draft Model Law, which were limited to provisions regarding Marketing, Consumer Notices and Opt-Out/Opt-In, reflected the following specific concerns from industry groups:

- ambiguities in the definition of joint marketing that would inadvertently cover a broader scope of agreements than intended;
- logistical hurdles surrounding the content and timing of delivery of consumer notices and consent requests;
- the inconsistency in the length of the notice look-back period proposed in the Model Law compared to the existing look-back period established under the California Consumer Privacy Act;
- the difficulty in aligning the Opt-Out/Opt-In scheme with existing federal regulations for financial institutions;
- the lack of specificity in the categories of personal information covered under the Model Law; and
- general concerns that the current Model Law framework deviates drastically from the existing regime established under the Privacy of Consumer Financial Health and Information Regulation (#672).

Additionally, in response to one industry comment, the Working Group noted that it plans to prepare a template for notices of privacy practices and consumer rights for different types of regulated entities in conjunction with the Model Law.

State-level interest in consumer data privacy protection legislation remains high. On June 30, 2023, Delaware's legislature passed the Delaware Personal Data Privacy Act. If

enacted, this bill would become the seventh state-level data privacy law passed this year, following the passage of similar legislation in Indiana, Iowa, Montana, Oregon, Tennessee and Texas. At least 16 additional states have introduced data privacy bills during the current legislative session. At the federal level, the Data Privacy Act of 2023 passed through the House of Representatives Financial Services Committee along party lines in February. The bill, which would create a preemptive ceiling and floor for consumer data protections in an attempt to establish a uniform federal privacy standard, has been criticized by House Democrats as a hinderance on states' abilities to enact stronger privacy regimes.

With a focus on investigating algorithmic bias, the **Property & Casualty Workstream** of the **Special (EX) Committee on Race and Insurance** is working collaboratively to build on best practices in marketing, access to insurance, underwriting, rating and claims handling, including fraud detection (in that order). The Workstream has already met with several insurers to discuss marketing and advertising and more recently underwriting, as well as to discuss algorithmic bias and its potential for creating unfair discrimination in various insurance functions. In addition to exploring best practices, the Workstream is also intent on learning more about corporate governance principals to inform its investigation and research.

Reinsurance

The **Financial Condition (E) Committee** adopted the reinsurance comparison worksheet prepared by the **Macprudential (E) Working Group**. The worksheet emerged during regulators' discussions about cross-border reinsurance, which were themselves the result of the NAIC's "Regulatory Considerations Applicable (But Not Exclusive) to Private Equity Owned Insurers" adopted by the NAIC in June 2022. The considerations identified 13 specific issues for regulators to review, including the use of offshore reinsurers and complex affiliated sidecar vehicles.

The worksheet is designed for regulators to assess cross-border reinsurance treaties where there are different regulatory regimes involved and give the reviewing regulators a mechanism to identify the true economic impact of a reinsurance transaction. During the worksheet's exposure period, industry participants had been particularly focused on (1) the fact that the information required is already provided elsewhere to regulators, (2) the fact that the worksheet should not be used to evaluate non-U.S. jurisdictions, given the NAIC already has an established process for evaluating "qualified" and "reciprocal" jurisdictions and (3) adding safeguards to protect confidential and proprietary information submitted to regulators. The adopted worksheet addressed these concerns through several clarifying instructions.

The adopted version of the worksheet states that it is designed as an optional tool rather than an obligatory ongoing filing and should not be used for all reinsurance transactions. For further information on this, please see our update from July 2023 [here](#).

Inter-Affiliate Agreements

The **Risk-Focused Surveillance (E) Working Group** adopted revisions to the NAIC's Financial Analysis Handbook and Financial Condition Examiners Handbook intended to guide regulators in their review of inter-affiliate service agreements. This guidance, to be included in each handbook, focused on cost-plus reimbursement agreements, explaining scenarios in which such agreements are appropriate and the responsibility of insurers to justify the rates utilized as fair and reasonable. In the course of adopting the revisions, the Working Group noted that not all members approved of the guidance contained in the proposed amendment, and, in light of comments received, agreed to remove references to such agreements as a "method of last resort," to the approval of industry commenters.

Additionally, the Working Group discussed its plans relating to the 2022 referral from the **Macprudential (E) Working Group** regarding affiliate investment management agreements and capital maintenance plans. Regulators presented several considerations for evaluating affiliate investment management agreements, including the presence of robust investment guidelines, fair termination provisions, procedures addressing conflicts of interest and reporting requirements appropriate for the applicable insurer. Following the presentation, the Working Group agreed to form a drafting group focused on the investment management agreement portion of its referral.

Diversity, Equity and Inclusion

The **Life Workstream** of the **Special (EX) Committee on Race and Insurance** last met on July 20, 2023 to discuss next steps related to marketing, distribution and access to life insurance products in minority communities, including examining the role that financial literacy plays. The Workstream has partnered with local organizations and government agencies to develop resources on life insurance for consumers. To improve access and understanding in underserved and minority communities, the Workstream plans to develop a resource guide. The resource guide is to be developed in collaboration between the NAIC and state diversity leaders. The intention is to increase the availability of resources on when to purchase life insurance and how to purchase the correct policy type, particularly to increase financial literacy in minority communities.

The Workstream plans to hold further calls, including one in October, seeking comments and feedback on the draft resources.

Climate Change

Following its 2022 referral to several **(E) Committee** working groups and technical groups, the **Climate and Resiliency (EX) Task Force** received an update from its **Solvency Workstream** that the **Financial Conditions Examiners' Handbook (E) Technical Group** and the **Financial Analysis Solvency Tools (E) Working Group** expect to finalize guidance intended to strengthen prudential oversight of the impact of climate change on the financial condition of insurers by the end of 2023.

The **Macroprudential (E) Working Group** will continue to update the macroprudential risk assessment dashboard to include climate risk metrics and a comparison of the Working Group's framework to the **Financial Stability Oversight Council's** framework, identify gaps and consider proposals on how to move the project forward.

International Relations

The **International Insurance Relations (G) Committee** discussed the **International Association of Insurance Supervisors'** ("IAIS") public consultation on the issues paper focused on the roles related to policyholder protection schemes. During the Meeting, the Committee considered (among other things): (1) analysis of market volatility, (2) the implications of reinsurance availability and affordability and (3) examining climate change and its impact on insurance. Also mentioned during an update presentation from the Canadian Office of the Superintendent of Financial Institutions was the potential to create partnerships with other governments, educators and other interested parties, to further promote international cooperation.

The IAIS conducted its Global Monitoring Exercise ("GME") with data calls and data analysis that included a focus on individual insurer monitoring and reviewing the quantitative data of about 60 insurers. The IAIS also conducted quantitative and qualitative sector-wide monitoring, looking at reinsurance and climate risk. Part of the framework of the IAIS is the GME, for the purposes of: (1) systemic risk identification; (2) taking a broader approach to financial stability; and (3) macroprudential surveillance. The IAIS's midyear Global Insurance Market Report update summarizes the initial outcomes of the GME, including the following broad areas: (i) solvency, liquidity and profitability; (ii) aggregate systemic risk scores; (iii) the

interconnectedness of insurance sector with the banking sector; (iv) managing interest rate, liquidity and credit risks in a challenging macroeconomic environment; (v) structural shifts in the life insurance sector—specifically the use of cross-border asset intensive reinsurance; and (vi) the increase risk of capital to alternative assets. These areas also broadly align with the takeaways from the IAIS’s Global Seminar in June 2023 and some of the areas we expect will form a key part of the IAIS’s 2025–2029 Strategic Plan (to be unveiled later this year.)

The **European Union (EU)-U.S. Insurance Dialogue Project** and a summary of its recent public stakeholder session in June 2023 was presented to the Committee. The upcoming comparability assessment project for the Aggregation Method (“AM”) was also discussed. This project is meant to determine whether the United States’ initial developments of the AM can provide comparable outcomes to the insurance capital standard. A U.S.-produced document describing the Provisional AM for use in the comparability assessment is currently open for feedback. The comparability assessment is scheduled to begin in Q3 2023.

Currently, the **Macprudential (E) Working Group** is conducting a holistic framework review of supervisory standards. Additionally, certain committees of the Working Group are reviewing sector-wide monitoring themes and future data collection points.

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Please do not hesitate to contact us with any questions.



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