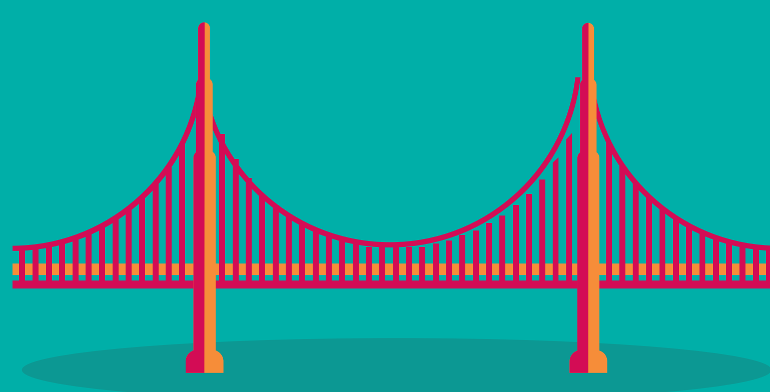
NAIC Fall Meeting

Issues & Trends



December 2018

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1 Meeting highlights

On conference calls and at its Fall meeting, the National Association of Insurance Commissioners (NAIC) **adopted** the following guidance.[1]

— Revisions to SSAP No. 30R expanding the definition of common stock to include US SEC registered closed-end funds and unit-investment trusts.
— Revisions to SSAP No. 86 incorporating the hedge effectiveness documentation requirements included in the recent targeted improvements to the US GAAP derivative accounting model. Effective January 1, 2019, with early adoption permitted for year-end 2018 and specific early adoption requirements for companies that also prepare US GAAP financial statements.
— SSAP No. 108 prescribing accounting and reporting guidance for derivatives that hedge the interest rate risk of variable annuity guarantees that are reserved under VM-21. Effective January 1, 2020, with early adoption permitted as of January 1, 2019.
— Modifications to the life principle-based reserving (PBR) exemption primarily removing the risk-based capital (RBC) requirement.
— Revisions to the Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation incorporating the relevant provisions of the Bilateral Agreement and extending similar treatment to other jurisdictions meeting similar criteria.

The NAIC **exposed** the following guidance.

— Revisions to various SSAPs indicating that structured notes, subject to some exceptions, should be reported as derivatives under SSAP No. 86.
— A template and corresponding instructions for testing the group capital calculation.

[1] The NAIC Fall meeting was held November 15-18 in San Francisco.

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Structured notes	SAPWG reexposed revisions to SSAP Nos. 2R, 26R, 43R and 86, indicating that structured notes that resemble debt instruments where the investor risks losing principal based on an underlying component unrelated to the credit risk of the issuer should be reported as derivatives under SSAP No. 86.[2] Comments are due February 15, 2019.
Prepayment penalties	SAPWG exposed revisions to SSAP No. 26R clarifying how to determine the prepayment penalty for called bonds when the consideration received is less than par. Comments are due February 15, 2019.
Common stock	SAPWG adopted an issue paper and revisions to SSAP No. 30R expanding the definition of common stock to include US SEC registered closed-end funds and unit-investment trusts, effective January 1, 2019.[3] SAPWG exposed a revision to SSAP No. 30R to include foreign mutual funds in its scope. Comments are due February 15, 2019.
Federal Home Loan Bank (FHLB)	SAPWG exposed revisions to SSAP No. 30R clarifying the accounting for assets pledged to FHLB on behalf of an affiliate. Comments are due February 15, 2019.
Mortgage loans	SAPWG exposed revisions to SSAP No. 37 clarifying that mortgage loans acquired through a participation agreement are limited to a single mortgage loan agreement and exclude bundled mortgage loans (e.g. an interest in a group of mortgage loans with various unrelated borrowers and collateral).[4]

[2] SSAP No. 2R, Cash, Cash Equivalents, Drafts and Short-Term Investments; SSAP No. 26R, Bonds; SSAP No. 43R, Loan-Backed and Structured Securities; SSAP No. 86, Derivatives

[3] SSAP No. 30R, Unaffiliated Common Stock

[4] SSAP No. 37, Mortgage Loans

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Loss tracking	SAPWG adopted revisions to SSAP No. 48 adding disclosures to capture information when an insurer's share of losses exceeds its investment in a joint venture, partnership or limited liability company.[5] Revisions will be effective December 31, 2018. SAPWG reexposed revisions to SSAP No. 97 that clarify when an insurer should report a negative carrying amount for a Subsidiary, Controlled and Affiliated (SCA) entity.[6] Comments are due February 15, 2019.
Derivatives and hedging	SAPWG adopted revisions to SSAP No. 86 incorporating the hedge effectiveness documentation requirements included in the recent targeted improvements to the US GAAP derivative accounting model. The revisions will be effective January 1, 2019, with early adoption permitted for year-end 2018. Insurers that also prepare US GAAP financial statements are permitted to early adopt only if they have early adopted the US GAAP targeted improvements for year-end 2018.[7]
Principle-based reserving (PBR) – Page 12	
Life PBR exemption	On a call before the Fall meeting, the Life Actuarial Task Force (LATF) adopted a proposal to modify the Life PBR exemption, primarily to remove the 450 percent RBC requirement.
Term life insurance	On a call before the Fall meeting, LATF exposed a definition of term life insurance. At the Fall meeting, the regulators discussed revisions based on comments received.
Yearly-renewable term (YRT) reinsurance premiums	LATF exposed revisions to VM-20 related to non-guaranteed YRT reinsurance premiums.[8] Comments are due January 31, 2019.

[5] SSAP No. 48, Joint Ventures, Partnerships and Limited Liability Companies

[6] SSAP No. 97, Investments in Subsidiary, Controlled and Affiliated Entities

[7] ASU 2017-12, Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities

[8] VM-20, Requirements for Principle-Based Reserving for Life Products

Principle-based reserving (PBR) – Page 12	
PBR review report	Before the Fall meeting, the Valuation Analysis Working Group (VAWG) released the 2017 PBR Review Report. At the Fall meeting, VAWG presented its findings and recommendations to revise the Valuation Manual. LATF requested that NAIC staff work with the California Department of Insurance to draft amendment proposal forms before the Spring 2019 meeting.
Variable annuities – Page 14	
Derivative contracts related to variable annuity products	SAPWG adopted SSAP No. 108 that prescribes accounting and reporting guidance for derivatives that hedge the interest rate risk of variable annuity guarantees that are reserved using VM-21.[9] The guidance will be effective January 1, 2020, with early adoption permitted as of January 1, 2019.
Variable annuity framework	On calls before the Fall meeting, the C-3 Phase II/AG 43 Subgroup exposed two documents. — Revised AG 43.[10] Comments were due November 9, 2018. — Sections 1–5 and sections 11-12 of VM-21. Comments were due November 19, 2018.
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Field testing approach	The Group Capital Calculation Working Group exposed a template and corresponding instructions for testing the group capital calculation. Comments are due January 30, 2019.
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Credit for Reinsurance Model Law and Regulation	The Reinsurance Task Force and its parent committee, the Financial Condition Committee, adopted the revised Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation. The Model Law and Model Regulation incorporate relevant provisions of the Bilateral Agreement and extend similar treatment to other jurisdictions meeting similar criteria.

[9] SSAP No. 108, Derivatives Hedging Variable Annuity Guarantees; VM-21, Requirements for Principal-Based Reserves for Variable Annuities

[10] Actuarial Guideline XLIII, CARVM for Variable Annuities

Risk-based capital – Page 18	
Bonds	The Health RBC Working Group agreed to send a letter to the Investment RBC Working Group about the use of the bond portfolio adjustment factor in the health RBC formula. On a call before the Fall meeting, the Investment RBC Working Group discussed comments about the: — American Academy of Actuaries' (Academy's) July 2018 letter about the statutory reserve offset included in the bond factors; and — Academy's Joint Property & Casualty (P&C)/Health Bond Factors Analysis Working Group report (Joint Report) with an analysis and recommended bond factors for the P&C and health RBC formulas. The chair of the Investment RBC Working Group said a summary document will be created to organize the suggestions from the comment letters.
Operational risk	On a call before the Fall meeting, the Operational Risk Subgroup exposed two documents. — Updated questions that will be used to solicit information about how firms identify and quantify operational risk. Comments are due December 14, 2018. — Options for a Health Growth Risk charge. Comments are due December 14, 2018. The Subgroup also discussed comments about an add-on approach for a Life RBC growth risk charge.
Other accounting highlights – Page 21	
Debt forgiveness between related parties	SAPWG adopted revisions to SSAP Nos. 15 and 25 clarifying the accounting when there has been a forgiveness of debt between related parties.[11]
Cloud computing arrangements	SAPWG considered two options to address the recent US GAAP accounting guidance for implementation costs of acquiring a cloud computing license.[12] It directed NAIC staff to propose revisions to SSAP No. 16R that would adopt the US GAAP guidance, with modification.[13]

[11] SSAP Nos. 15 and 25, Debt and Holding Company Obligations; Affiliates and Other

[12] ASU 2018-15, Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract

[13] SSAP No. 16R, Electronic Data Processing Equipment and Software

Other accounting highlights – Page 21	
Structured settlements	SAPWG adopted revisions to SSAP No. 21 adding accounting and reporting guidance for structured settlement income streams acquired by insurers as investments.[14] The revisions will be effective December 31, 2018.
Liquidity disclosures	SAPWG adopted revisions to SSAP Nos. 51R, 52 and 61R that will give regulators the ability to focus on product areas with greater liquidity risk. The disclosures add product-level granularity to the existing disclosures for annuity actuarial reserves and deposit-type liabilities by withdrawal characteristics, and add similar disclosures to life products.[15] The new disclosures will be effective for year-end 2019.
Prepayments for claims and adjusting services	SAPWG exposed revisions to SSAP No. 55 clarifying the accounting for prepayments to providers for claims and adjusting services.[16] Comments are due February 15, 2019.
Reinsurance	SAPWG adopted revisions to SSAP No. 62R adding previously referenced US GAAP guidance, effective January 1, 2019.[17] SAPWG discussed comments about previously exposed revisions to SSAP No. 61R and Appendix A-791 that proposed disclosures and clarified guidance about the applicability of A-791.[18] It forwarded concerns expressed by two regulators about group term YRT contracts to the informal Life and Health Drafting Group for consideration.

[14] SSAP No. 21, Other Admitted Assets

[15] SSAP No. 51R, Life Contracts; SSAP No. 52, Deposit-Type Contracts; SSAP No. 61R, Life, Deposit-Type and Accident and Health Reinsurance

[16] SSAP No. 55, Unpaid Claims, Losses and Loss Adjustment Expense

[17] SSAP No. 62R, Property and Casualty Reinsurance; EITF Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises; EITF Topic No. D-35, FASB Staff Views on Issue No. 93-6

[18] Appendix A-791, Life and Health Reinsurance Agreements

Other accounting highlights – Page 21	
Mergers	SAPWG adopted revisions to SSAP No. 68 clarifying that transactions where the parent absorbs the assets and liabilities of an SCA entity are considered statutory mergers.[19]
Fair value	SAPWG exposed revisions to SSAP No. 100R to adopt with modification recently revised US GAAP guidance about fair value disclosures. Comments are due February 15, 2019.[20]
Credit losses	Before the Fall 2018 meeting, the NAIC staff confirmed that the intent of the proposed modifications was to utilize an approach similar to the US GAAP available-for-sale investment guidance, with the inclusion of a fair value floor. SAPWG will discuss comments on the proposal.

[19] SSAP No. 68, Business Combinations and Goodwill

[20] SSAP No. 100R, Fair Value

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Investments

Structured notes

Action. SAPWG reexposed revisions to SSAP Nos. 2R, 26R, 43R and 86, indicating that structured notes that resemble debt instruments where the investor risks losing principal based on an underlying component unrelated to the credit risk of the issuer should be reported as derivatives under SSAP No. 86. The exposed revisions included a proposal to add mortgage-referenced securities in the scope of SSAP No. 43R and include guidance about when an other-than-temporary impairment for these instruments may have occurred. Comments addressing whether structured notes should be classified as mandatorily convertible bonds or derivatives are due February 15, 2019.

Interested parties supported the proposed definition of structured notes and agreed that they should be recorded at fair value. However, they suggested that these instruments should remain in the scope of SSAP No. 26R rather than SSAP No. 86. Interested parties also supported the proposed exemption that would keep mortgage-referenced securities within the scope of SSAP No. 43R, but proposed some revisions to the language.

SAPWG continues to assert that structured notes are in-substance derivatives with a wrapper and are significantly different from mandatorily convertible securities. The reexposure reflects the same concepts as the original document and incorporates interested party suggestions to modify the other-than-temporary impairment guidance for mortgage-referenced securities in SSAP No. 43R to include expected recoveries.

Prepayment penalties

Action. SAPWG exposed revisions to SSAP No. 26R clarifying how to determine the prepayment penalty for called bonds when the consideration received is less than par. Comments are due February 15, 2019.

When the consideration received is less than par for a called bond, the revisions state that the insurer should:

— review each bond individually under the terms of the bond and call provisions to determine the existence of a prepayment penalty or acceleration fee;
— report the prepayment penalty or acceleration fee received as investment income; and
— calculate the resulting realized gain or loss, after determining any prepayment penalty or acceleration fee.

SAPWG requested comments about whether additional illustrations should be included or existing illustrations eliminated or condensed.

Common stock

Action. SAPWG adopted an issue paper and revisions to SSAP No. 30R expanding its scope to include US SEC registered closed-end funds and unit-investment trusts. These changes will be effective January 1, 2019.

Interested parties supported the changes and the effective date. However, they expressed concern that the revised scope does not include foreign open-ended mutual funds that are structured similarly to SEC registered mutual funds and have published net asset values.[21]

Action. SAPWG exposed a revision to SSAP No. 30R to include foreign mutual funds in its scope. Comments are due February 15, 2019.

SAPWG also asked for comments about whether:

- the scope should be limited to only mutual funds from certain jurisdictions;
- Canadian mutual funds should continue to be considered domestic under current annual statement instructions;
- foreign mutual funds should be captured in the Supplemental Investment Risk Interrogatory as foreign investments; and
- clarification is needed to specify that only SEC registered mutual funds that qualify for diversification are excluded from the Asset Concentration Factor section of the risk-based capital filing.

Assets pledged to FHLB

Action. SAPWG exposed revisions to SSAP No. 30R clarifying the accounting for assets pledged to FHLB on behalf of an affiliate. Comments are due February 15, 2019.

The revisions clarify that:

- assets pledged to FHLB on behalf of an affiliate should be nonadmitted because they are not under the reporting entity's exclusive control and are not available to satisfy policyholder obligations;
- the guidance is specific for insurers that are FHLB members; and
- transactions entered into on behalf of an affiliate, excluding affiliate involvement, are related party transactions under SSAP No. 25.

SAPWG requested comments on activities that occur involving non-FHLB member affiliates when a reporting entity is an FHLB member.

Mortgage loans

Action. SAPWG exposed revisions to SSAP No. 37 clarifying that mortgage loans acquired through a participation agreement are limited to a single mortgage loan agreement and exclude bundled mortgage loans. Comments are due February 15, 2019.

[21] Foreign mutual funds are funds registered outside of the United States and that are registered under the specific rules and regulations of the foreign country.

The intent of the changes is to clarify that investments such as pools of mortgages and loan funds are excluded from the scope of SSAP No. 37. The proposed revisions clarify that investments in the scope of SSAP No. 37 must be a:

— single mortgage agreement; and
— cannot include bundled mortgage loans (e.g. an interest in a group of mortgage loans with various unrelated borrowers and collateral).

Loss tracking

Action. SAPWG adopted revisions to SSAP No. 48 adding disclosures to capture information when an insurer's share of losses results in a negative equity position. Revisions will be effective December 31, 2018.

Interested parties expressed some concerns with the proposed disclosures, including that they could be viewed as duplicative because SSAP No. 48 entities are subject to the equity method accounting requirements of SSAP No. 97. They recommended adding language clarifying when insurers would be subject to the disclosures.

SAPWG agreed with the interested party recommendation and modified the proposed revisions to specify that a reporting entity whose shares of losses in an SSAP No. 48 entity exceeds its investment shall disclose the information required by SSAP No. 97.

Action. SAPWG reexposed revisions to SSAP No. 97 clarifying existing reporting requirements about when an insurer should report a negative carrying amount for an SCA entity. It directed NAIC staff to work with interested parties and research applicable US GAAP guidance to consider revisions that would require reporting a negative SCA entity when there is a guarantee or commitment to provide financial support. Comments are due February 15, 2019.

SAPWG previously exposed revisions to clarify circumstances when a reporting entity's negative equity value should be reported as a contra-asset. Interested parties expressed concern that the proposed guidance:

— included reporting negative equity resulting from statutory adjustments that were not related to operational losses; and
— would have caused an understatement of surplus when an insurer had guaranteed obligations or committed further financial support to an SCA entity.

Derivatives and hedging

Action. SAPWG adopted revisions to SSAP No. 86 incorporating the hedge effectiveness documentation requirements included in the recent targeted improvements to the US GAAP derivative accounting model. The revisions will be effective January 1, 2019, with early adoption permitted for year-end 2018.

Insurers that also prepare US GAAP financial statements are permitted to early adopt only if they have early adopted the US GAAP targeted improvements for year-end 2018.

These revisions allow insurers to:

- perform subsequent assessments of hedge effectiveness qualitatively if certain conditions are met;
- take more time to perform the initial qualitative hedge effectiveness assessment; and
- apply the critical terms match method for a group of forecasted transactions if the transactions occur and the derivatives mature within the same 31-day period or fiscal month, and the other requirements for applying the critical terms match method are satisfied.

3 Principle-based reserving

Life PBR exemption

Action. On a call before the Fall meeting, LATF adopted a proposal to modify the Life PBR exemption to:

— clarify that insurers are required to file a statement of exemption with the domiciliary regulator;
— remove the 450 percent RBC requirement;
— clarify that guaranteed issue policies are excluded from ordinary life insurance premiums; and
— add a statement that each exemption, or lack of one, applies to policies issued or assumed in the current year and to all future valuation dates.

Interested parties supported the changes, specifically as they relate to the removal of the 450 percent RBC requirement.

Term life insurance

Action. On a call before the Fall meeting, LATF exposed a definition of term life insurance. At the Fall meeting, the regulators discussed revisions based on the comments received.

On calls before the Fall meeting, LATF discussed the definition of term life insurance including which products should be included. The proposed definition would apply for the purposes of VM-20 and VM-31, and excludes endowment policies.[22] One of the questions considered was whether graded premium whole life (GPWL) products should be included.

Some regulators thought that GPWL products should not be included in the definition of term life insurance because it provides coverage for the policyholder’s lifetime. Interested parties also expressed concern about including extended term insurance because it may result in unintended consequences when calculating the net premium reserve, which was calibrated for traditional term products with level premiums followed by increasing premiums after the term period. They also stated that GPWL products and other non-traditional term products should be excluded.

Yearly renewable term reinsurance (YRT) premiums

Action. LATF exposed revisions to VM-20 on the treatment of non-guaranteed YRT reinsurance premiums. Comments are due January 31, 2019.

[22] VM-31, PBR Actuarial Report Requirements for Business Subject to a Principle-Based Valuation

Two insurers expressed concern that VM-20 currently allows ceding and assuming parties to assume different future rate increases for non-guaranteed YRT premiums that could lead to disappearing reserves on the transfer of risk. They expressed their view that the ceding party should not assume a credit on reserves greater than a one-year mean reserve for non-guaranteed YRT. Otherwise, there may be a loss of reserves on the transfer of risk due to inconsistent expectations of future non-guaranteed premiums. The two insurers proposed to amend VM-20 to increase the YRT scale for the cedent, which would raise reinsurance premiums so that the present value of future reinsurance premiums equals the present value of future reinsurance benefits.

PBR review report

Before the Fall meeting, the VAWG released the 2017 PBR review report that:

- provides a summary of the process to review the VM-20 reserve supplements and the PBR actuarial reports filed for the 2017 calendar year-end; and
- documents the major observations and findings.

The observations are based on 23 companies in 17 states that chose to implement PBR. The report provides information for companies to better understand expectations of the regulators when preparing PBR filings and documentation that demonstrates compliance with the requirements of the Valuation Manual. It also gives regulators who were not involved in the review process information to look for when conducting a PBR review and examination.

The report addresses areas where:

- documentation was missing or needs to be expanded or clarified;
- results were incomplete or incorrect; and
- requirements were misunderstood.

At the Fall meeting, VAWG presented its findings and recommendations to revise the Valuation Manual to address concerns about:

- organization and communication;
- information required by VM-31 in the Valuation Manual that was not provided;
- additional information not provided but needed to evaluate PBR implementation; and
- other methodology, modelling or assumption issues.

Next steps. LATF requested that NAIC staff work with the California Department of Insurance to draft amendment proposal forms before the Spring 2019 meeting.

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Variable annuities

Derivative contracts related to variable annuity products

Action. SAPWG adopted SSAP No. 108 prescribing accounting and reporting guidance for derivatives that hedge interest rate risk of variable annuity guarantees that are reserved under VM-21. Guidance will be effective January 1, 2020, with early adoption permitted as of January 1, 2019.

The provisions of this guidance include these items.

- All designated hedging instruments will be reported at fair value.
- In a highly effective hedging strategy, changes in the fair value of the hedging instruments attributable to the hedged risk that:
  - offset the current period change in the designated portion of the reserve liability are recognized as a realized gain or loss;
  - do not offset the current period change in the designated portion of the reserve liability are recognized as deferred assets and liabilities;
  - are not attributable to the hedged risk are recognized as unrealized gains or unrealized losses.
- An amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies/programs within SSAP No. 108) is allocated from unassigned funds to special surplus.
- Deferred assets and deferred liabilities are amortized into realized gains or losses using a straight-line method over a timeframe that is equal to the Macaulay duration of the guarantee benefit cash flows based on the VM-21 Standard Scenario, not to exceed 10 years.

Variable annuity framework

Action. On calls before the Fall meeting, the C-3 Phase II/AG 43 Subgroup exposed two items.

- Revised AG 43. Comments were due November 9, 2018.
- Sections 1–5 and sections 11 – 12 of VM-21. Comments were due November 19, 2018.

The C-3 Phase II/AG 43 Subgroup has been charged to take the framework developed by the NAIC and Oliver Wyman and propose changes to C-3 Phase II, AG 43 and VM-21 to implement that framework.[23] The goal is for the NAIC Executive Committee and Plenary to adopt these changes at the 2019 Summer meeting with an effective date of January 1, 2020.

[23] Actuarial Guideline XLIII—CARVM for Variable Annuities

The Subgroup plans to present its recommendations to its parent groups, the Life Risk-Based Capital Working Group and the Life Actuarial Task Force, at the 2019 Spring National Meeting.

The Subgroup held weekly calls beginning in September to discuss the changes to VM-21 and AG 43 as proposed by the drafting group. The drafting group is comprised of regulators, industry representatives, representatives from the ACLI, representatives from Oliver Wyman and members of the American Academy of Actuaries AG 43/C3 Phase II Work Group.

Next steps. The Subgroup will continue to have weekly calls.

5

Group capital calculation

Field testing approach

Action. The Group Capital Calculation Working Group (GCCWG) exposed a template and corresponding instructions for testing the group capital calculation. Comments are due January 30, 2019.

On a call before the Fall meeting, the GCCWG discussed comments about the group capital calculation proposal from a joint group of trade associations, including questions added by NAIC staff.

The chair of GCCWG stated that the field test should provide information to better evaluate some of the decisions that will need to be made after the field test. Two regulators commented that the scope of the field test should be broad and not eliminate any useful information. They acknowledged that the scope of the field test does not have to be the final scope of the calculation. The Academy agreed with casting a wide net for field testing and also provided technical comments about the calculation.

Most interested party comments included support for:

- a widespread field test to give regulators a broad view of how it would affect different companies, however, some asserted that the final calculation should exempt companies that are not required to file an Own Risk and Solvency Assessment;
- an iterative testing approach that would allow flexibility in testing; and
- a principle-based approach with respect to determining materiality of the entities in the group.

However, some interested parties continued to assert that the group capital calculation should be rooted in a state legal authority without adjustment and not conflict with the existing tools such as the risk-based capital calculation. One interested party also stated that field testing was premature because key issues such as the treatment of senior debt, centralized internal services versus external providers, the scope of the group, and application of scalars remained unresolved.

At the Fall meeting, the GCCWG presented the initial draft of the field testing template. The GCCWG said that this should not be considered a final product, and is designed to provide information to analyze how data behaves before deciding on a final approach. The goal is to begin the field test in March 2019 using final 2018 data.

6

Covered agreement

Credit for Reinsurance Model Law and Regulation

Action. The Reinsurance Task Force and its parent committee the Financial Condition Committee adopted the revised Credit for Reinsurance Model Law (Model Law) and Credit for Reinsurance Model Regulation (Model Regulation) that incorporate relevant provisions of the Bilateral Agreement and extend similar treatment to other jurisdictions meeting similar criteria.

Before the Fall meeting the Reinsurance Task Force reexposed the Model Law and Model Regulation that included:

- requiring that a Reciprocal Jurisdiction recognize the full system of US insurance regulation;
- defining the terms 'solvent scheme of arrangement' and 'head office or domicile';
- clarifying the consequences of suspension or revocation of eligibility of the assuming insurer under subsection two of the Model Law;
- removing the requirement for the audited financial statements of the reinsurer to include a reconciliation between IFRS and US GAAP bases; and
- adding specific events that would require the assuming insurer to provide written notice and explanation to the commissioner.

During the meeting, the Reinsurance Task Force reviewed additional revisions based on comments received. These revisions primarily clarified the existing requirements within the Model Law and Model Regulation, including which reinsurance contracts will be subject to the Model Law (effective date language).

Interested parties generally supported the revisions. However, some expressed concern that the Model Law and Model Regulation may provide international reinsurers with better access to US markets than domestic reinsurers. They requested that domestic reinsurers be added to the definition of Qualified Jurisdictions. Interested parties also requested that the Task Force consider some technical changes including revising the effective date language.

The Task Force stated that it did not intend to provide unequal treatment and agreed to have the Reinsurance Financial Analysis Working Group examine that issue. It also agreed to decide whether additional technical changes are needed before the Executive and Plenary Committee will consider its adoption in December 2018.

In September 2017 the United States and the EU signed a Bilateral Agreement, also referred to as the Covered Agreement. The agreement eliminates collateral and host country physical presence requirements for reinsurers operating on a cross-border basis. It also enables jurisdictions to recognize each other's system of solvency and market conduct regulation. States will need to take action with respect to reinsurance collateral reforms within 60 months or be subject to potential federal preemption.

7

Risk-based capital

Bonds

On a call before the Fall meeting, the Health RBC Working Group agreed to send a letter to the Investment RBC Working Group recommending that the bond portfolio adjustment factor be reflected in the health RBC formula. The Academy recommended that the factor be added to reflect the average bond portfolio of health insurers.

Next steps. Health RBC Working Group will work on developing the portfolio adjustment factor and plans to implement it concurrently with the change in overall bond factors.

On a call before the Fall meeting, the Investment RBC Working Group discussed comments about the Academy's Joint Property & Casualty (P&C)/Health Bond Factors Analysis Working Group report (Joint Report). The Joint Report included an analysis and also recommended bond factors for the P&C and health RBC formulas and the Academy's risk premium assumption on bond model report.

Interested parties generally supported the proposals within the joint report. Their comments included:

— supporting segmenting investment and non-investment grade bonds;

— agreeing with using a liability runoff time horizon instead of a credit cycle because it more closely matches assets with liabilities;

— questioning if an investment income offset should have been considered in developing the factors; and

— requesting that the factors be stated to the nearest hundredth of a percent.

The Academy said that there is an investment income offset for the P&C formula. However, if the model were adjusted, the entire statutory framework would need to have restrictions on the release of investment income for profit, if it was assumed that the investment income would reduce the development of capital factors.

The Academy also agreed to provide factors to the nearest hundredth of a percent.

Interested parties continued to express concern about the Academy's report on premium assumptions. They commented that the:

— application of the new portfolio adjustment factor will require more capital and will significantly affect smaller and mid-size companies; and

— proposed C-1 factors place too much reliance on emerging history and that the slope between the investment grade and below-investment grade factors is flat compared with the current C-1 factors and other capital models that have a steeper slope.

The Academy responded that the slope of recommended factors is flatter compared with the rating agency's due to recovery assumptions instead of default rates. One reason for different factors is because of a shorter time horizon and the ability to change the rating on a bond. The Academy stated that if the risk premium is changed it could affect the Asset Valuation Reserve and asset adequacy, and reiterated that the formula:

- increases the representative portfolio for all life bonds an insurer would purchase (i.e. greater than 840 bonds); and
- calculates base factors at the 96th percentile with the portfolio adjustment factor reflecting only diversification.

Next steps. The chair of the Investment RBC Working Group stated that a summary document will be created to organize the suggestions provided in the comment letters.

Operational risk

Quantification of operational risk

Action. On a call before the Fall meeting, the Operational Risk Subgroup exposed updated questions to solicit information about how firms identify and quantify operational risk.[24] Comments are due December 14, 2018.

The Subgroup stated that the goal of collecting additional information is to better understand and refine the way operational risk is recognized for solvency purposes. The data would be gathered to determine what information could be most beneficial and consider whether establishing an operational risk database could be useful. The Subgroup requested specific comments about how information could be collected (i.e. RBC reports or regulator questions based on ORSA review) and coordinated among regulators on a timely basis.

Health growth risk

Action. On a call before the Fall meeting, the Operational Risk Subgroup exposed options for Health Growth Risk. Comments are due December 14, 2018.

The exposed document includes:

- a description of the current Health RBC growth risk methodology;
- considerations in developing the existing methodology;
- observations about the methodology;
- reasons to consider a change;
- a description of a possible alternative approach; and
- options for transition to the Health RBC Working Group.

[24] The Operational Risk Subgroup defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events; it excludes strategic and reputational risk.

Life RBC growth risk charge

On a call before the Fall meeting, the Operational Risk Subgroup discussed comments about an add-on approach for Life RBC Growth Risk charge. The approach proposes to use the growth benchmarks in the informational approach. It also would apply the add-on factor to RBC after covariance, which would be based on growth that exceeds the defined thresholds individually or alternatively on a combined basis. This would be added to the basic operational risk and be subject to the C-4a offset.

Interested parties did not support the additional charge, and presented some of their observations.

- The charge that is based on year-over-year changes would not be appropriate because of the long duration nature of life insurance business.
- The add-on method appears to be arbitrary and not risk sensitive.
- There are existing tools in place to identify fast-growing life insurers that may warrant increased regulatory attention.
- The additional charge may disproportionately affect reinsurers because they would not have the C-4a offset.

8

Other accounting highlights

Debt forgiveness between related parties

Action. SAPWG adopted revisions to SSAP Nos. 15 and 25 clarifying the accounting when there has been a forgiveness of debt between related parties.

The revisions state that under SSAP No. 72 forgiveness of a reporting entity's:[25]

— obligation to its parent or other stockholder should be accounted for as contributed surplus; and

— debt, surplus note or other obligation of its parent or other stockholder should be accounted for as a dividend.

Based on the responses from interested parties about questions included in the exposure, SAPWG determined that additional guidance about related party transactions is not needed.

Cloud computing arrangements

SAPWG considered two options to address the recent US GAAP accounting guidance for implementation costs of acquiring a cloud computing license for statutory accounting.

Option 1. Treat as part of lease cost and expense when incurred.

Option 2. Treat similar to a software development cost and capitalize the nonoperating system software costs, and then nonadmit the asset with amortization not to exceed 5 years, consistent with current guidance for nonoperating system software.

SAPWG acknowledged that these costs can be significant and decided that Option 2 would be preferable.

Next steps. SAPWG directed NAIC staff to propose revisions to SSAP No. 16R that would adopt the US GAAP guidance, with modification. In the exposure, SAPWG will request comments about whether implementation costs would meet the definition of operating system software and whether they could be bifurcated between operating and nonoperating system software.

[25] SSAP No. 72, Surplus and Quasi-Reorganizations

Structured settlements

Action. SAPWG adopted revisions to SSAP No. 21 adding accounting and reporting guidance for structured settlement income streams acquired by insurers as investments. The revisions will be effective December 31, 2018.

This guidance applies to insurers that acquire structured settlement payment rights as a result of a structured settlement factoring transaction and requires insurers to report:

— period-certain, non-life contingent, structured settlement income streams as other long-term invested assets, and admitted if the rights to the future payments from a structured settlement have been legally acquired; and
— life contingent structured settlement income streams as other long-term invested assets on Schedule BA and nonadmitted.

Liquidity disclosures

Action. SAPWG adopted revisions to SSAP Nos. 51R, 52 and 61R that enhance existing disclosures about annuity actuarial reserves and deposit-type liabilities to include withdrawal characteristics. The revisions will be effective for year-end 2019.

The Financial Stability Task Force developed enhanced liquidity disclosures to focus on potential product areas with greater liquidity risk in the life insurance industry. These disclosures add granularity to the current annuity liquidity disclosure, and deposit-type contracts without life contingencies. A new disclosure is added to provide similar disclosure for life products.

Prepayments for claims and adjusting services

Action. SAPWG exposed revisions to SSAP No. 55 clarifying the accounting for prepayments to providers of claims and adjusting services. Comments are due February 15, 2019.

The revisions state that:

— prepayments should be reported as miscellaneous expense;
— when claims are paid, a proportionate percentage of the prepayment is reclassified from miscellaneous underwriting expense to claims adjustment expense or claims expense, as applicable; and
— prepayments not related to services or adjusting for the underlying direct policy benefits should remain in miscellaneous underwriting expenses.

Reinsurance

Action. SAPWG adopted revisions to SSAP No. 62R adding previously referenced US GAAP guidance, effective January 1, 2019.

The revisions clarify how the reinsurance credit is determined and incorporate language from US GAAP guidance that was referenced within the SSAP.

SAPWG discussed comments about previously exposed revisions to SSAP No. 61R and Appendix A-791 that proposed disclosures and clarified guidance about the applicability of A-791.

Two regulators expressed concern about the reinsurance credit and risk transfer for YRT contracts. They stated that proposed changes did not address the treatment of YRT treaties that cede group term life risk with the primary purpose of achieving risk-based capital relief. In their view these contracts can be structured to substantially mitigate or eliminate risk transfer to the assuming reinsurer by taking a greater portion of reinsurance premium than the proportional premium on the underlying direct premium.

In previous discussions, regulators expressed concern about quota share short-duration health reinsurance contracts with features that limited the reinsurer's risk. They said that:

— those contracts were reported as meeting the risk transfer requirements under statutory accounting, but were not meeting the risk-transfer requirements under US GAAP; and
— similar reinsurance contracts that may meet risk transfer requirements for statutory accounting were taking a larger reinsurance accounting benefit than what was appropriate because features in the reinsurance contracts were limiting the actual amount of risks transferred.

Next steps. SAPWG forwarded concerns expressed by the two regulators to the informal Life and Health Drafting Group for consideration.

Mergers

Action. SAPWG adopted revisions to SSAP No. 68 clarifying that transactions where the parent absorbs the assets and liabilities of an SCA entity are statutory mergers.

Previously, SSAP No. 68 identified mergers only as one entity issuing new equity or debt to acquire another entity and only one entity survives. It did not address when a parent absorbs the assets and liabilities of an SCA entity.

Fair value

Action. SAPWG exposed revisions to SSAP No. 100R to adopt with modification revised US GAAP guidance about fair value disclosures. Comments are due February 15, 2019.

Proposed revisions would:

— clarify the objective of the disclosure;
— eliminate information about transfers between level 1 and level 2 for items measured and reported at fair value;

- eliminate the disclosure of a reporting entity's policy for determining when transfers between levels have occurred; and
- amend the disclosures about the calculation of net asset value.

Credit losses

Before the Fall 2018 meeting, the NAIC staff confirmed that the intent of the proposed modifications included in the discussion document was to utilize an approach similar to the US GAAP available-for-sale investment guidance, with the inclusion of a fair value floor. SAPWG expects to receive comments from interested parties to continue its discussion.

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Acknowledgments

This edition of Issues & Trends has been produced by the insurance practice of the Department of Professional Practice of KPMG LLP in the United States.

We would like to acknowledge the efforts of the main contributors to this Issues & Trends.

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