Risks Other than Credit Technical Resource Subgroup
Of the Invested Asset (E) Working Group
Record of the 05/26/10 Conference Call
By Robert Carcano, Senior Counsel, SVO

SubGroup Members on the Call: Kevin Fry (IL), Chair: Kim Hudson (CA); Elaine Wieche (CT); Alex Hart (MD); Constance Peterson (MN); Matti Peltonen (NY); Tim Hays (WA); Marvin Smith (Aflac); David Berger (Ameriprise); Jim Olsen (PCI); Chris Anderson (Anderson Insights); Robert Lynch (MetLife); Samantha Hairfield (GenWorth); Nancy Bennett (AAA); Victor Makarov (MetLife); Holly Roland (Principal); Andrew Melnyk (ACLI); Betsy Ward (Babson); Robert Carcano (NAIC); Joseph Prakash (NAIC); Ed Toy (NAIC); Dan Swanson (NAIC) and Richard Newman (NAIC).

Mr. Fry asked for comments on the summary of the May 12 call. No comments were offered and the summary was received.

Mr. Fry asked Mr. Peltonen and Mr. Anderson to review the report of the technical resources subgroup that identified investment risks in fixed income securities. The following key points were made during this discussion: [1]

- The risk based capital (RBC) framework assumes all credit ratings are the same regardless of asset class or issuer. This assumption needs to be reconsidered.
- Was counter-party risk included in the definition of credit risk?[2] Anything that caused non-performance over the time period is reflected in the factors for credit risk. However, the focus was on fixed income securities, not on derivatives.
- Deferral risk, typically expressed in contractual language, is captured in the bond characteristic column and in C-1 (given that preferred stock ratings are lower than those for the issuer's senior bond.
- Was the possible decline in the market value of a security (not caused by default) discussed? Market risk was not identified as an individual security risk.
- Was liquidity risk measured on the bid/ask spread? The group did not address how liquidity should be measured. The preference was to assign different values to different types of securities to facilitate comparison between insurance companies.

[1] This document omits the discussion lead by Mr. Peltonen and Mr. Anderson on investment risks in fixed income securities because this was a summary of material contained in written documentation. Please refer to the official documentation created by the previous technical resources subgroup.
[2] Mr. Makarov posed the questions in this section and Mr. Peltonen and or Mr. Anderson responded.

(c) 2010 National Association of Insurance Commissioners

- Was the impact of catastrophic events considered? No. Event risk might be reflected in credit risk over time. Catastrophic risk is also implied in liquidity risk given the impact a catastrophe could have on liquidity.

- Constant Proportion Debt obligations are an example of a product with significant leverage and CMO's are an example of leverage caused by interest rate movements.

- Was prepayment risk associated with mortgages deemed part of call risk? The risk is associated with call risk and there may be a special definition of prepayment on asset liability in the ALM construct which the group may want to look at. However, because in this situation prepayment is directly related to changes in interest rates, it was not looked at on a security by security basis.

- Each of the risks was mapped back to elements of existing regulatory oversight included: RBC (either C-1 or C-3), AVR/IMR, the examiners handbook, cash flow testing for life companies and bond characteristics on Schedule D.

Ms. Hairfield asked for clarification on the objective. Mr. Carcano said that regulators feel that the annual statement blanks and other tools that exist today do not provide clearly visible information on the nature of the securities or the kinds of risks associated with them. A key project objective is to create tools that capture and show these risks and to do so using high quality data from reliable third party vendors. Mr. Fry said that reporting on these risks is buried where regulators cannot see them. The objective is providing the framework for a better dialog with companies based on a detailed understanding of risks in the portfolio. A key reason to form this subgroup is to develop a process that resembles what insurers use to assess risks in their portfolios. We are trying to get regulators thinking like companies do when they look at their portfolio of invested assets.

Ms. Hairfield asked if the new framework would result in an additional concentration charge for the various risk when regulators are still receiving the concentration charge in C-3. Mr. Fry said the first objective was to quantify the risk before any decisions can be made as to what additional regulation is required. The SVO found that almost all of the risks could be quantified in some way although not all of them could be quantified into RBC. Mr. Carcano added that the biggest issue; i.e., determining the relative materiality of the risk to the insurer has never been addressed because the current process focuses only on credit risk. Mr. Anderson said the first subgroup distinguished between individual security risks (and some mapping) and non individual security risks not whether the current process deals with those risks adequately.

Ms. Bennett said that we can't look at risk in a vacuum. Mr. Fry agreed and said that regulators want the ability to ask the right question. He knows regulators can't assume these risks are bad. By asking the right question the regulator can learn more about the liability side of the balance sheet. Mr. Fry said that the liability side of the balance sheet

is another area that he feels there is not enough transparency in. So he would not rule out the possible need to consider greater disclosure on the liability side.

Mr. Toy said that right now, with the exception of pure default risk we don't have a process that permits regulators to look at, measure and compare the materiality of that risk so that relevant questions can be asked. The end result is that examiners and regulators in general are put in the position of asking lots of questions about virtually everything because they don't have the complete set of tools.

Ms. Hairfield asked for clarification about best practices that the ACLI was asked to assist with. Mr. Carcano said the idea, from Mr. Anderson, was that insurance company risk managers could help regulators understand how they identify and manage risks exist in a portfolio. Mr. Anderson said the idea was to take advantage of the substantial body of work companies have done in their own risk management areas.

Ms. Hairfield asked if the industry was being asked to think about specific asset risks or comment on best practices for these already outlined seven specific risks. Mr. Toy said that it is more the latter. The question is how industry measures risks because we are going to start coming up with some ideas and we would like it to be in a format that fits within the context of what the industry already does.

Mr. Fry said he felt the subgroup should start with the best practices presentation: to permit the industry to discuss how individual security risks are monitored and if they are monitoring risks other than the ones that were previously identified, he would like to see those.

Mr. Carcano said that it could be useful to understand if risk is conceived differently depending on the precise book of business of a particular company and how that is relevant to the process that we intend to build. Mr. Carcano also said it would be helpful to see if there were other risks that would be relevant in addition to the seven the first group identified. Much of the current regulatory framework for invested assets appears to be changing so this is actually a good time to consider wholesale improvements.

Ms. Bennett said that maybe regulators could more specifically describe the type of information they would want. Is it a brand new report or additional disclosure and what regulatory group the ultimate product will be directed at.

Mr. Fry said that the product would be directed at the insurance department analyst. This person goes to I-site to pull very rudimentary data: the summary investment schedule is 20 years old and outdated at this point; the analyst can't even bucket things into meaningful asset classifications to understand the holdings because Schedule D is organized in such a way that's things are all over the place and the analyst can't map them. We want to replace this with a snapshot summary schedule that is now in testing. The idea is to be able to drill down in to the asset classes of this summary investment schedule to get specific information about the securities that make up that class and get a better idea of the risks associated in them. Mr. Peltonen added he does not get much out

(c) 2010 National Association of Insurance Commissioners

of cash flow testing. He would like to see the interim steps rather than the end product and to assess whether the company can survive some of those scenarios.

Ms. Bennett asked if the regulator side of the team could put together a list of the gaps in the information you are getting so the industry representative side could develop a list of best practices in managing these risks. This might help us figure out where the gaps are and how the information can best be provided to the regulatory community.

Mr. Carcano said the objective here is to create a new mechanism. The concern is that the current process is already too unwieldy: that trying to "fix" it creates issues for other constituencies;" that it relies on insurer supplied data that is not very reliable and that it would be less expensive and time consuming for everyone to simple build a new tool. The new tool would perform three key functions: 1) it would capture data about securities from reliable third party vendors that describe the attributes of the security 2) add information about the risks that exists in each of these securities and aggregate this information into discrete tallies.

Mr. Fry said the regulatory side would put something together that would describe the issues that we are having with our current structure, share the new summary investment snapshot we are working on and get the group Mr. Peltonen's work paper on liquidity. Mr. Carcano said that the staff would also distribute the SVO staff report on RBC and quantifying the risks other than credit.

Mr. Fry asked that the IP's put something together on best practices. He asked them to think of what they would show to their management to give them an understanding of the risks that they face and how they are being managed. He wants to see what they show to key people to show that they are mitigating the risks that their company faces. Maybe we'll also need to get a better understanding of the liability side.

Mr. Melnyk said he thought the IP's had a much better understanding of what Mr. Fry is looking for.

Having not further business the call ended.