Client Update
NAIC 2016 Fall National Meeting

NEW YORK
Alexander R. Cochran
arcochran@debevoise.com

Eric R. Dinallo
edinallo@debevoise.com

Thomas M. Kelly
tmkelly@debevoise.com

Marilyn A. Lion
malion@debevoise.com

Nicholas F. Potter
nfpotter@debevoise.com

Eugene Benger
ebenger@debevoise.com

Michael Coburn
jmcoburn@debevoise.com

Dexter Hoffman
dhoffman@debevoise.com

Khrystyna Rayko
krayko@debevoise.com

The National Association of Insurance Commissioners (NAIC) held its 2016 Fall National Meeting from December 10 to 13, 2016 in Miami, Florida. This client update highlights some of the developments from the Fall National Meeting that are of particular interest to many of our insurance industry clients, including developments relating to:

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For purposes of this report:

- "ACLI" means the American Council of Life Insurers.
- "ComFrame" means the Common Framework for the Supervision of International Active Insurance Groups.
- "EU" means the European Union.
- "FIO" means the Federal Insurance Office of the U.S. Department of the Treasury.
- "FSB" means the Financial Stability Board.
- "G-SII" means a global systemically important insurer.

- "IAIS" means the International Association of Insurance Supervisors.
- "IAO" means the NAIC Investment Analysis Office.
- "IMF" means the International Monetary Fund.
- "ORSA" means Own Risk Solvency Assessment.
- "PBR" means Principle-Based Reserving.
- "RBC" means NAIC risk-based capital.
- "SIFI" means a systemically important financial institution.
- "SVO" means the NAIC Securities Valuation Office.

(1) LIFE INSURER DEVELOPMENTS

Principle-Based Reserving

The **Principle Based Reserving Implementation (EX) Task Force** reported that it is working with the American Academy of Actuaries and the Society of Actuaries to offer both web-based and onsite training programs in preparation for PBR going into effect on January 1, 2017. Approximately 20 companies are expected to use PBR with at least one product in 2017. The Task Force is also in the process of creating a **Valuation Analysis (E) Working Group** charged with calibrating companies' PBR models. The Task Force received an update from the **Principle Based Reserving Review (EX) Working Group** on the status of the 2016 PBR pilot project involving the Kansas Insurance Department and 11 participating companies. The Working Group plans to present the results of the pilot project in late January.

The **Financial Regulation Standards and Accreditation (F) Committee** exposed the **Life Actuarial (A) Task Force** referral regarding the PBR revisions to the Standard Valuation Law for a 60-day comment period ending February 8, 2017. The Committee will subsequently consider which elements of the referral to include in the accreditation standard for PBR. One open question noted in the referral and discussed by members of the Committee is whether states should be required to apply the Valuation Manual to fraternal benefit societies.

Variable Annuities Issues (E) Working Group

The **Variable Annuities Issues (E) Working Group** continues to meet via conference call in order to prepare for a second Quantitative Impact Study (QIS2) by Oliver Wyman of the proposed revisions to AG 43 and C3 Phase II. The Working Group intends to complete QIS2 by late August 2017 and to present the

results of the testing at the 2017 Fall National Meeting. Many stakeholders and some regulators appeared skeptical that the Working Group could meet such an ambitious timeframe. The current proposal has both a stochastic framework and a standard scenario which was originally intended to act as a floor. Interested parties were concerned that the standard scenario is currently dominant over the stochastic scenarios and not behaving effectively as a floor.

Life Insurance Illustrations

The **Life Insurance and Annuities (A) Committee** adopted a revision to Actuarial Guideline 49, "The Application of the Life Insurance Illustrations Model Regulation to Policies with Index-Based Interest" (AG 49), that would make the provisions of Sections 4 and 5 applicable to in-force life insurance illustrations regardless of the date the policy was sold. Sections 4 and 5 provide guidance in determining the maximum crediting rate for the illustrated scale and earned interest rate for the disciplined current scale. Until being amended, these provisions applied to all new business and in-force life insurance illustrations on policies sold on or after September 15, 2015. The amendment makes all in-force life insurance illustrations, regardless of when the policy was sold, subject to AG 49. When the **Life Actuarial (A) Task Force** approved this amendment in November, the effective date was set for July 1, 2017. The Committee, however, adopted New York's suggestion to move the effective date up to March 1, 2017 based on the comments of a consumer representative. The amendment, including the March 1, 2017 effective date, was later adopted by the **Executive Committee and Plenary**.

(2) PROPERTY/CASUALTY INSURER DEVELOPMENTS

The **Big Data (D) Working Group** discussed the creation of the new **Big Data (D) Task Force**, whose mission will be to gather information to assist regulators in obtaining a clear understanding of what data is collected, how it is collected and how it is used by insurers and third parties in the context of marketing, rating, underwriting and claims. The Task Force will also evaluate whether data is being used in a manner compliant with state insurance laws and regulations.

The Working Group also discussed its 2017 proposed charges, which include reviewing the current regulatory frameworks used to oversee insurers' use of consumer and non-insurance data, proposing a mechanism to provide resources and allow states to share resources to facilitate the states' ability to conduct technical analysis of, and data collection related to, the states' review of complex models used by insurers for underwriting, rating and claims and assess the data needs and required tools for regulators to appropriately monitor the marketplace and evaluate underwriting, rating, claims and marketing practices.

Interested parties expressed general support for the 2017 proposed charges and stressed the importance of the Task Force monitoring potential discriminatory uses of data. Members of the Working Group and interested parties also agreed that, although it is essential to monitor insurers' uses of big data, it is also important to recognize the potential benefits such uses offer to consumers.

(3) CAPTIVE REINSURANCE

Term and Universal Life Insurance Reserve Financing Model Regulation

The **Executive Committee and Plenary** officially adopted the Term and Universal Life Insurance Reserve Financing Model Regulation (formerly called the XXX/AXXX Credit for Reinsurance Model Regulation) and amendments to Actuarial Guideline 48 (AG 48) to make it as consistent as possible with the Term and Universal Life Insurance Reserve Financing Model Regulation (Reserve Financing Model Regulation), effective January 1, 2017. The Reserve Financing Model Regulation is intended to be a new accreditation standard.

In considering the amendments to AG 48, the NAIC explained that AG 48, which applies to XXX/AXXX reinsurance transactions entered into on or after January 1, 2015, was intended to be replaced by a revised Credit for Reinsurance Model Law (which was adopted by the NAIC on January 8, 2016) and by a new model regulation to establish requirements for the reinsurance of XXX/AXXX policies (i.e., the Reserve Financing Model Regulation). Thus, AG 48 will cease to be effective in states that enact the revised Credit for Reinsurance Model Law and adopt the Reserve Financing Model Regulation.

Because both AG 48 and the Reserve Financing Model Regulation apply to ceded XXX/AXXX policies that were issued on or after January 1, 2015, the adoption of the Reserve Financing Model Regulation, no matter when adopted, would completely displace AG 48 with respect to new XXX/AXXX policies as well as in-force policies that had been subject to AG 48.

The NAIC anticipates, however, that a small number of states will adopt the Reserve Financing Model Regulation on a prospective basis only, so that it would apply to ceded policies issued on or after the effective date of the Reserve Financing Model Regulation, but not to ceded policies issued on or after January 1, 2015 and before the effective date of the Reserve Financing Model Regulation. In those states, AG 48 will remain in force for ceded policies to which the Reserve Financing Model Regulation does not apply. The revisions to AG 48 are meant to avoid confusion and ensure uniformity of treatment between states,

companies, and ceded policies that may be governed by AG 48 or the Reserve Financing Model Regulation.

Compliance with Part A Standards

The **Financial Regulation Standards and Accreditation (F) Committee** received an update regarding compliance with the new Preamble to the Part A: Laws and Regulations Accreditation Standards, which the Committee adopted at the 2015 Summer National Meeting. The Part A Preamble became effective on January 1, 2016 with respect to XXX/AXXX reinsurance captives, and while it applies also to variable annuity captives and long-term care insurance captives, no effective date has been determined with respect to these captives while the NAIC continues to study regulatory issues related to them.

In 2016, NAIC staff assessed compliance with the new requirements related to captive reinsurers that assume XXX/AXXX business. The NAIC concluded that all reviewed transactions showed that an appropriate amount of securities were being held, which satisfies the Part A standards. The NAIC did note, however, that some confusion existed among insurers regarding the information to be reported under the new Part A. To address this, the NAIC plans on providing additional guidance regarding the reporting process.

(4) CYBERSECURITY

The **Cybersecurity (EX) Task Force** heard an update from the NAIC regarding federal cybersecurity legislation. The NAIC noted that the Federal Reserve, the FDIC and the Office of the Comptroller of the Currency recently put forth an advanced notice of proposed rulemaking on Enhanced Cyber Risk Management Standards that would apply to federally regulated institutions, including non-bank SIFIs. The NAIC also reported that the President's Commission on Enhancing National Cybersecurity, which seeks to collect information and make cybersecurity recommendations, recently delivered a report to the President. The report provides specific recommendations to the current administration on strengthening cybersecurity in the public and private sectors and securing and growing the digital economy. The Task Force reported that President Obama requested that the Commission brief President-elect Trump on the report at the earliest opportunity.

The Task Force also noted that the Data Breach Insurance Act (HR 6032) was introduced in Congress in September. The bill would amend the Internal Revenue Code to provide tax credits to businesses for purchasing data and cybersecurity insurance, provided that businesses adopt the NIST Cybersecurity Framework, the International Organization for Standardization or a similar

specified standard. Although the bill did not make it out of committee, the NAIC anticipates that it will be reintroduced when the new Congress convenes in January.

Insurance Data Security Model Law

The Task Force heard a report from the drafting group of the Insurance Data Security Model Law (Model Law), which aims to establish uniform standards for data security and data breach notification applicable to insurance companies. The drafting group reported that, after reviewing comments on the second draft of the Model Law released in August 2016, it has determined that there are six primary issues for consideration: (i) how to address state uniformity and exclusivity; (ii) whether and how to include an exemption for licensees subject to federal HIPAA or GLBA law; (iii) whether to include a harm trigger in the definition of "data breach"; (iv) the scope of the definition of "personal information"; (v) how to address scalability of information security requirements for smaller licensees; and (vi) how to address licensee oversight of third-party service providers. The drafting group is focusing on these items as it prepares the third draft of the Model Law.

(5) INTERNATIONAL INSURANCE ISSUES

U.S.-EU Regulatory Relations

The Committee heard an update on U.S.-EU insurance regulatory matters, including the potential impact of new regulatory actions taken by some European jurisdictions as part of their implementation of Solvency II. These include actions taken by Belgium, similar to those taken by Germany, that require reinsurers interested in doing business in certain EU countries to have a branch in the country or post collateral, though the collateral requirement is not well defined.

With these EU regulatory developments in mind, the **Reinsurance (E) Task Force** discussed the possibility of revoking the status of the four EU countries that are "qualified jurisdictions" for purposes of the certified reinsurer regimes in the U.S. The Task Force, which requested at the 2016 Summer National Meeting that the **Qualified Jurisdiction (E) Working Group** study and report on the implementation by EU member states of Solvency II and the potential impact on qualified jurisdiction status, exposed the Working Group's report on the potential impact on the qualified jurisdiction status of France, Germany, Ireland and the UK for a 30-day public comment period ending January 10, 2017. However, other than exposing the report, the Reinsurance Task Force said it was too early to debate whether to actually revoke the qualified jurisdiction status.

Negotiations for a covered agreement between the U.S. and the EU, which would presumably include "temporary equivalence" under Solvency II as well as collateral reduction for EU reinsurers, were ongoing with reports coming out that the FIO is optimistic that a draft agreement will be reached soon. There is some timing pressure as the implementation of the impediments to doing business in certain EU jurisdictions will go into effect in 2017 and the fate of the FIO in the new administration is uncertain.

IAIS Activities

The **International Insurance Relations (G) Committee** adopted the reports of its working groups, including a report from the **ComFrame Development and Analysis (G) Working Group** that addressed the process of submitting NAIC responses to the IAIS on its insurance capital standard (ICS) consultation document and receiving regulator input on the ICS in general as it continues to develop.

The Committee heard an update on the ICS, which is expected to be released by the IAIS as version 1.0 in June 2017. Representatives from the IAIS and the Bank of England offered an update on ICS developments, including the recent consultation, and responded to questions from Committee members and interested parties. The IAIS stressed that version 1.0 is just a draft and is not for implementation and outlined the stages of decision making, with the goal of dealing with most of the substantive issues by the end of April 2017. During the question and answer session, interested parties expressed concern about releasing a draft that is not finalized and about the number of volunteers participating in field testing.

Additionally, the Committee explained that the IAIS adopted an Application Paper on Approaches to Supervising the Conduct of Intermediaries at its annual conference in November, but has delayed until March 2017 the release of a number of revised Insurance Core Principles (ICPs) and the draft ComFrame material. The Committee said that the FSB, in consultation with the IAIS and national authorities, identified nine insurers as G-SIIs in November. Members of the Committee also noted that the IAIS has made a commitment to greater transparency of the G-SII assessment process, is exploring an activities-based approach to systemic risk, has concluded that the loss-absorbing capacity (LAC) in resolution should not be established for G-SIIs at this time, and, through its Resolution Working Group, continues to revise ICP 12, "Winding-up and Exit from the Market."

(6) CORPORATE GOVERNANCE

ORSA Implementation

The **Group Solvency Issues (E) Working Group** adopted a report from the **ORSA Implementation (E) Subgroup**, which discusses comments received regarding ORSA information-sharing best practices and proposed next steps for the Subgroup. The Subgroup likely will eventually oversee the development of the NAIC ORSA Guidance Manual and may also develop more formal ORSA review guidance for inclusion in the NAIC's Financial Analysis Handbook and Financial Condition Examiners Handbook. However, the Subgroup indicated that it is not ready to move forward with these initiatives yet and will likely continue to meet in regulator-only sessions until that time.

The Working Group discussed draft interpretive guidance designed to clarify regulator information reporting expectations on the Enterprise Risk Report (Form F) reporting process. At the 2016 Summer National Meeting, the Working Group reviewed results of a survey distributed to NAIC members in May 2016 assessing the effectiveness of the Form F reporting process. The survey revealed states' dissatisfaction with the Form F process. To address these concerns, the Working Group asked the NAIC staff to draft a non-authoritative guidance manual to provide interpretive guidance on regulator information reporting expectations. An initial draft of the guidance was introduced to the Working Group on October 28, 2016 and exposed for comment.

The Working Group and interested parties discussed a comment letter on the guidance received by New York suggesting that the Form F should be a narrative report rather than a form. This suggestion was rejected by other states, who expressed that a narrative report would go beyond the intended scope of Form F. Interested parties also expressed opposition to the use of a guidance manual, saying that it would imply mandatory compliance, and instead suggested the use of a memorandum. The Working Group recognized these concerns and requested that NAIC revise the guidance in accordance with directions received from the Working Group.

(7) GROUP-WIDE SUPERVISION

Group Capital

The **Group Capital Calculation (E) Working Group** continued to work on developing an inventory-based methodology for calculating group capital, which would create an inventory of all of the entities in a group and identify certain financial factors associated with each entity, such as the authorized control level

regulatory capital amount and the total available capital amount. Additionally, the Working Group is weighing different approaches for calculating the scalars to apply to non-U.S. insurers.

The Working Group will conduct baseline testing of group calculation in early 2017, which will serve as a vehicle for experimentation with various proposals. The Working Group aims to begin field testing of its group capital proposal in July 2017 and complete testing by the 2018 Summer National Meeting. There was no discussion of the potential effect that the presidential election might have on group capital regulations and the need to comply with international standards. More attention was focused on the substance of the group capital proposal, including fundamental questions of scope (the current proposal would apply to all insurers regardless of size) and the potential for internationally active insurers to become subject to multiple regulators and group capital standards.

(8) RISK-BASED CAPITAL DEVELOPMENTS

RBC Factors for Bonds and Common Stocks

The **Investment Risk-Based Capital (E) Working Group** is continuing to work on updating the life risk-based bond factors from six to approximately 20 in order to add granularity to the Life RBC formula. The ACLI expressed concern that the proposed bond factor framework would increase life RBC by more than 10% and shift incentives from investment grade to below investment grade bonds. The ACLI presented an alternative framework that it believes better reflects past experience. The Working Group expressed willingness to incorporate the ACLI's concerns into their current model but rejected calls to start over with a new bond factor framework. In addition, the Working Group planned to examine updating the bond factors for property/casualty and health insurers, with the goal applying the same factors consistently across all three kinds of insurance.

The **Valuation of Securities (E) Task Force** discussed a referral from the **Investment Risk-Based Capital (E) Working Group** pertaining to the proposal to expand the RBC categories for bonds. The Academy of Actuaries (Academy) suggested that the categories be based on the credit rating assigned to a bond by a nationally recognized statistical ratings organization (NRSRO). The IAO was asked to review the proposal and express a preliminary opinion. The IAO expressed concern that the "RBC Factor Category" to be created under the proposal is independent of NAIC processes and could therefore undermine the meaning of NAIC designations. The IAO believes it is possible to quantitatively link the default probabilities and RBC categories in the Academy proposal to

NAIC designations. The Task Force asked the IAO to develop recommendations to address the Academy proposal.

The IAO also was directed to draft an amendment to the Practices & Procedures Manual that would discuss the regulatory nature and purposes of NAIC designations to further distinguish NAIC designations from credit ratings provided by credit rating providers. The Task Force released the amendment for a 120-day comment period and no comments were received. NAIC staff asked that the adoption of this text be deferred to prevent potential disruptions to conversations between the NAIC and IAIS on a capital standard that incorporates the use of credit ratings by international companies and the role of NAIC designations for U.S. companies with group operations. The Task Force agreed to defer action until the NAIC has concluded the discussions and directed NAIC senior managers to advise the IAO when the IAO can put this item back on the agenda for adoption.

Operational Risk Charge

The **Life Risk-Based Capital (E) Working Group**, **Health Risk-Based Capital (E) Working Group** and **Property and Casualty Risk-Based Capital (E) Working Group** each received an update from the **Operational Risk (E) Subgroup** regarding a new operational risk charge for the 2017 RBC report. An informational operational risk charge was previously included in the 2015 and 2016 RBC report.

The charge will contain two components: a charge for growth risk and a charge for basic operational risk. The charge for basic operational risk will be set as a percentage of total RBC. Life insurers already have an equivalent business risk charge. The new operational risk charge will act as a floor for life insurers, going into effect only if it exceeds the current business risk charge. The charge for growth risk will add an additional charge if growth in premiums exceeds a certain threshold. Health and property/casualty insurers already have an excessive growth charge while life insurers do not.

(9) INSURANCE TECHNOLOGY

Blockchain

The **Financial Condition (E) Committee** heard a report from Symbiont, a technology company, on potential applications of blockchain technology in the insurance industry. Blockchain technology, which is best known as being the underlying technology used by Bitcoin, allows multiple participants to efficiently share a common database. A number of large insurers, including John Hancock,

Allianz, Swiss Re and Munich Re, have already begun using blockchain technology to streamline back office functions. The current system of custody arrangements does not allow tracking of beneficial ownership of securities. As a result, insurance regulators have a limited ability to ensure that the securities listed in an insurer's Schedule D are in fact held by that insurer. Indeed, studies have indicated that multiple financial institutions regularly report holding the same securities. Symbiont asserted that by using blockchain technology to create a centralized, commonly accessible database, insurance regulators would be able to track beneficial ownership and, in turn, would be better able to measure an insurer's solvency.

InsurTech

The NAIC Center for Insurance Policy & Research (CIPR) held a session entitled "Regulatory Evaluation 2.0: Meeting the Challenges of Innovation" during which panelists discussed InsurTech trends from the perspectives of the insurance industry, the technology start-ups, regulators and consumer advocates.

The theme from the regulatory perspective was to encourage early, open and honest communications between InsurTech start-ups and regulators given that the ability to test new ideas in a regulated insurance market is highly complicated. A consumer advocate suggested that an enormous amount of innovation has already taken place under the regulatory radar, including an increase in the use of non-personal consumer information for marketing, underwriting, pricing and settling claims, without oversight (or even awareness) by regulators.

(10) RECEIVERSHIP AND INSOLVENCY

The **Receivership and Insolvency (E) Task Force** adopted reports from the **Receivership Model Law (E) Working Group** (Model Law Working Group) and the **Receivership Technology and Administration (E) Working Group** (Technology Working Group). The Model Law Working Group communicated its plan to develop guidance on state reciprocity provisions related to stays and injunctions in connection with insurer receivership proceedings. The Model Law Working Group also noted that its 2017 proposed charges relate to the impact of long-term care insurance on guaranty associations, and stated that it would report back to the Task Force on its findings and any suggested amendments to the Life and Health Insurance Guaranty Association Model Act by the end of 2017.

The Task Force heard an update from the NAIC regarding federal legislative developments. The NAIC reported that in 2014 and 2015, the U.S. Treasury and

the Federal Reserve proposed new rules governing liquidity coverage ratios and margins for swap dealers, which include newly proposed definitions of master netting agreements. Under the new definitions, stays under the Dodd-Frank Act and other federal and international laws are recognized, but there is no recognition of state-based stays. As a result, insurers are concerned that they will face higher credit and collateral charges from counterparties, making it more difficult for them to enter into netting agreements. The NAIC has communicated these concerns to the various federal regulators and submitted a comment letter to the Federal Reserve, urging that the definition of eligible master netting agreements include state law.

Assets on Deposit as Restricted Assets

During the 2016 Summer National Meeting, the Task Force received and discussed a referral from the **Capital Adequacy (E) Task Force** regarding the classification of "assets on deposit with states for the benefit of all policyholders" as a restricted asset. The Task Force noted that by classifying such assets as restricted, the reporting entity incurs an additional RBC charge. Given that the purpose of requiring assets to be held on deposit is to protect policyholders, questions were raised whether such additional charges are prudent.

At the Fall National Meeting, the Technology Working Group responded to the referral, which was adopted by the Task Force, concluding that, although state deposits are generally not available in receivership, an additional RBC charge on such deposits is not warranted because doing so would not resolve the issue of availability.

(11) FINANCIAL STABILITY (EX) TASK FORCE

Insurance Sector Investments and Financial Stability

The **Financial Stability Task Force** heard a presentation on the results of an empirical study conducted by the Geneva Association on insurance sector investments and their impact on financial stability. The study focused on insurers' investment behavior and its impact on financial stability, with a special focus on hypothetical large-scale asset sales as an extreme example of investor herding behavior. The study was motivated by growing concerns among supervisory bodies (such as the Bank of England, the European Systemic Risk Board and the IMF) that insurance sector investments may impact markets and contribute to procyclicality, and by studies by academics and central bankers that seem to support the procyclicality suspicion.

The study considered the aggregate behavior of the whole insurance sector, with a focus on the impact of insurance sector investment behavior over time and relative to other large institutional investors. It also analyzed periods of stress in the financial markets and the market impact of hypothetical large-scale asset sales (the study included hypothetical extreme stress scenarios in which insurers dispose of large blocks of financial assets). The results of the stress scenarios indicated that even under significant shocks, large-scale asset sales by insurers have a negligible impact on financial market prices and that the insurance industry is relatively stable and less volatile. Under very extreme conditions (e.g., the recent global financial crisis), there could be visible price impacts in certain asset classes, but they do not have systemic implications that would require market stabilizing government intervention. The study's conclusion was that the business model of insurers does not trigger procyclical investment behavior that is likely to cause systemic distortions and that policymakers should avoid creating incentives that weaken the ability of the insurance sector to absorb financial market distress.

(12) VALUATION OF SECURITIES TASK FORCE

The **Valuation of Securities (E) Task Force** discussed a referral from the **Statutory Accounting Principles (E) Working Group** on a proposal from BlackRock for a systematic value calculation methodology for Exchange Traded Funds (ETFs). The IAO was asked to evaluate systematic value calculation. The IAO reported that the methodology produced a relatively stable book value when there were no material changes to the cash flows but produced minimal changes in amortization and book values when the ETF was subjected to a 20% permanent impairment of future cash flows. The IAO believes that the methodology would not support IAO credit quality assessment of ETFs because it would not signal a change in market value or cash flow variations of the underlying portfolio in the period between annual reviews. The IAO also believes that the methodology would not support statutory accounting objectives because it would not identify when the economic performance of the ETF investment is or could be permanently diminished. BlackRock agreed with the IAO's conclusion but stated that the issues identified would be addressed under the statutory accounting impairment guidance. The Task Force referred the IAO report back to the Working Group along with any supporting materials provided by BlackRock that address the impairment issue.

The Task Force adopted a report of the **Reporting Exceptions Analysis (E) Working Group** and determined that effective July 1, 2017, insurers would annually confirm the credit rating assigned to securities subject to private rating letters by filing a copy of the rating letter with the SVO pending an agreement by

credit rating providers to provide them as data to the SVO in an electronic data feed. Eligible credit ratings verified by the SVO would be converted to NAIC designations in the valuation of securities process and the insurer would file unverified securities with the SVO for analysis or take a 5 or a 6 designation.

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Please do not hesitate to contact us with any questions.