NAIC Summer National Meeting Capital Framework Discussion

Global Insurance Solutions

As of August 2019

ON AUGUST 3–6, WE ATTENDED THE NAIC SUMMER NATIONAL MEETING IN NEW YORK, NY, TO STAY INFORMED FOR YOU ON IMPORTANT REGULATORY ISSUES THAT ARE AFFECTING THE INSURANCE INDUSTRY TODAY. SUMMARIZED IN THIS DOCUMENT ARE THE MOST RELEVANT SESSIONS AND DISCUSSIONS FROM THE MEETING.

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INVESTMENT-RELATED RISK-BASED CAPITAL UPDATES—KEY TOPICS (Full details below)

- **The NAIC released a proposal to reduce the Life Risk-Based Capital (RBC) charge for equity investments held over a long horizon that back long-term liabilities:** In response to challenges due to the low interest rate environment following the financial crisis, the Life RBC Working Group (LRBCWG) has put forth a proposal that would reduce equity C-1 charges by half for unaffiliated equities held for at least seven years, via equity RBC credits
- **The Capital Adequacy Task Force (CAdTF) will consider integrating comprehensive instructions for mutual funds into the RBC framework:** The Valuation of Securities Task Force (VOSTF) has requested that the CAdTF consider formally integrating comprehensive instructions for mutual funds into the RBC framework, with the goal of further accommodating mutual funds that predominantly hold bonds
- **The CAdTF will assess RBC charges for structured notes, in response to accounting-related guidance revisions:** The Statutory Accounting Principles Working Group (SAPWG) has identified potential limitations that exist when determining carrying values for structured notes. The CAdTF will assess the appropriate RBC charges for structured notes, as well as the elements used in determining the RBC, AVR and IMR

PROPOSAL TO REDUCE LIFE RBC CHARGES FOR EQUITY INVESTMENTS HELD OVER A LONG HORIZON

During a recent LRBCWG conference call, the Allstate Corporation put forth a proposal to the Working Group that would reduce the RBC C-1 charges for unaffiliated equities by half, to 15% pre-tax, for equities held for at least seven years that back long-term, contractual obligations not subject to disintermediation risk (e.g., payout annuities, structured settlements, etc.). One of the biggest challenges for insurers since RBC was introduced 20+ years ago is the decline in returns from high-quality fixed income investments. Current C-1 capital charges provide buffers for potential losses in statutory asset values from bond defaults and the depreciation of common stock. Life insurers are currently required to hold a pre-tax capital charge of 30% on equity holdings, regardless of the nature of their

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EXHIBIT 1: S&P 500—HISTORICAL TAIL OUTCOMES (CUMULATIVE TOTAL RETURNS) FOR THE PERIOD 1946–2012*

	Horizon (years)							
	1	2	3	5	7	10	15	20
PERCENTILE	LOW WATERMARK RETURN			FULL PERIOD CALCULATION				
90	-14.1%	21.3%	-27.9%	3.2%	25.5%	46.5%	150.8%	291.4%
92	-16.9%	-25.2%	-30.8%	1.3%	21.3%	41.4%	143.1%	269.0%
94	-19.4%	-29.2%	-34.0%	-2.9%	17.2%	33.2%	133.7%	234.5%
95	-20.5%	**-30.5%**	-36.0%	**-5.3%**	15.6%	30.7%	127.9%	195.8%
96	-22.5%	-33.5%	-38.3%	**-7.2%**	13.1%	21.9%	124.7%	155.9%
97	-24.4%	-36.7%	-39.7%	**-9.3%**	9.5%	4.1%	120.7%	134.3%
99	-37.0%	-43.9%	-44.7%	**-12.8%**	**-5.9%**	**-13.0%**	104.7%	72.7%

Source: NAIC Life Risk-Based Capital Working Group—Proposal to Update RBC Charge for Unaffiliated Common Stock Supporting Long-Horizon

*Based on a 2013 study submitted to the Investment RBC Working Group titled "Life Insurer C-1 Asset Risk-Based Capital Requirement - Common Stock," which used a 2-year horizon, quarterly periodicity and a low watermark methodology. Current RBC equity charges of 30% were further validated by the 2013 study on common stock C-1 charges, which also recommended a 30% charge is based on a 95th percentile outcome (boxed blue). 5-13% charges were more appropriate for a five-year or longer horizon (boxed purple). Allstate's proposal recommends a conservative 15% equity charge with a seven-year minimum horizon.

liabilities. Allstate's proposal notes that investment theory has consistently demonstrated that equities are a very important component of diversified portfolios for investors with long time horizons. Its proposal also details that over the long term, equities have both higher returns and lower tail risk than bonds. The current risk and capital frameworks fail to incorporate the latter, as they embed some forms of asset diversification but ignore the concept of time diversification. Over the course of long horizons, winning and losing periods partially offset, resulting in smoother performance and lower tail risk (**EXHIBIT 1**). Investments in equities to support long-term, illiquid contractual obligations have been used successfully by retirement plans for the benefit of generations of consumers. The proposal therefore argues that the RBC system should be modernized to reflect the changing external environment and introduce time diversification, allowing companies to diversify their investment risk, which will strengthen their long-term financial ability to meet the guarantees provided to customers.

The proposal includes a revision to the RBC ratio calculation, along with additional reporting requirements to ensure transparency on assets receiving the RBC credits. Annual gains and losses on the affected equities will be amortized into the numerator and denominator of the RBC ratio over a period of seven years, while revisions would also be needed for the Life Blanks and RBC instructions to incorporate the changes.

The proposal also includes guardrails (**EXHIBIT 2**) crafted in coordination with regulators to ensure the credits are applied appropriately, along with actuarial and management

EXHIBIT 2: TIME DIVERSIFICATION RBC CREDIT FOR EQUITIES—CRITERIA AND GUARDRAILS

Guardrail	Description / rationale
Long Horizon Requirement	• Equities must back reserves held for seven years or more
Fixed Cash Flow Requirement	• Reserves must not be subject to discretionary withdrawals that could shorten the time horizon
ALM Strategy Requirement	• An effective strategy must be in place to mitigate short-term liquidity risk
Actuarial Certification & Supporting Memorandum	• Required to provide documentation and transparency into the C-1 credit and Capitalization Ratio adjustments
Segmentation	• Require separation of long duration assets to enhance transparency
Capitalization Ratio Amortization	• Adjust capital charges and Capitalization Ratio in consistent fashion • Amortize the volatility associated with equities receiving the time diversification credit into the Capitalization Ratio over a seven-year period • Apply the amortization only to investments consistently managed to a long horizon, using a combination of formal rules and/or certifications

Source: NAIC Life Risk-Based Capital Working Group—Proposal to Update RBC Charge for Unaffiliated Common Stock Supporting Long-Horizon certifications that will assist in providing an audit trail for regulators monitoring the credits. The NAIC has exposed the proposal for industry comments, with comment letters due back by September 20. The NAIC also noted that no immediate action on the proposal should be expected to come from regulators, as they continue to assess its viability and potential application.

THE CADTF WILL CONSIDER INTEGRATING COMPREHENSIVE INSTRUCTIONS FOR MUTUAL FUNDS INTO THE RBC FRAMEWORK

The VOSTF has formally requested that the CAdTF consider further integrating comprehensive instructions for mutual funds into the RBC framework, with the goal of further accommodating mutual funds that predominantly hold bonds or preferred stock. This change would entail assigning bond RBC factors to all bond and preferred stock funds, better aligning with the SVO[1] goal to ensure consistent treatment for all investments in bond funds. This also highlights the NAIC's emphasis on equalizing the RBC treatment for assets with similar credit and default risk, minimizing the importance of structure when analyzing funds (the CAdTF has acknowledged that separate funds could, for example, have identical holdings, but are treated differently for RBC because of fund structure).

The comprehensive fund proposal, which was adopted at the Spring National Meeting[2] in April, sought to bring clarity to the treatment of fund holdings, assessments performed by the SVO and the eligibility of NAIC designations. Around the same time, SAPWG also announced a project to expand the scope of *SSAP No. 30R – Unaffiliated Common Stock* to bring in scope funds issued by closed-end management companies and unit investment trusts, while also expressing support for adding a column to Schedule D, Part 2-2 that would permit funds designated by the SVO to be reported on that schedule with an NAIC designation that could align with an RBC factor to be determined by CAdTF. The CAdTF noted that it will have NAIC staff continue to work on policy revisions related to this matter, with an outcome scheduled to be completed in 2020.

THE CADTF WILL ASSESS THE APPROPRIATE RBC CHANGES NEEDED FOR STRUCTURED NOTES

During the Spring National Meeting in April, the SAPWG adopted an agenda item that clarified the accounting and reporting guidance for structured notes. Structured notes, as defined by NAIC guidance, are investments structured to resemble a debt instrument, but for which the contractual amount of the instrument to be paid at maturity (or the original investment) is at risk for other than failure of the borrower to pay the contractual amount due. Therefore, structured notes (excluding mortgage-referenced securities[3] or U.S. TIPS[4]) are considered derivative instruments, captured in scope of *SSAP No. 86 – Derivatives.*

With the adoption of these revisions, the SAPWG issued a referral to the CAdTF to assess the appropriate RBC charges for structured notes. Structured notes are reported at fair value on Schedule DB. This carrying value is also used to determine the RBC required to be held on these instruments. With a structured note, the principal amount to be returned is contingent on the specific performance of an underlying variable (e.g., an equity index). Because of this, determining the RBC amount off of fair value, as well as how gains and losses are reported through IMR/AVR, may not be suitable in its current form, and a consideration of potential exposure, for example, may be more appropriate in certain situations. The CAdTF has decided to place this item for review within its working agenda, with a resolution scheduled to be finalized during the 2020 calendar year.

1 NAIC's Securities Valuation Office
2 https://am.jpmorgan.com/us/institutional/our-clients/naic-2019-spring-meeting-notes

3 Examples of which include FNMA (Fannie Mae), FHLMC (Freddie Mac), FHLB MBS and GNMA (Ginnie Mae). These are covered within *SSAP No. 43R – Loan-Backed and Structured Securities*
4 Treasury Inflation-Indexed Securities – U.S. Treasury bonds indexed to inflation; protects against the negative effects of rising prices. They are also backed by the full faith and credit of the U.S. government.

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