NAIC Fall National Meeting Capital Framework Discussion

Global Insurance Solutions

As of January 2020

ON DECEMBER 7-10, WE ATTENDED THE NAIC FALL NATIONAL MEETING IN AUSTIN, TX 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.

GLOBAL INSURANCE SOLUTIONS

J.P. Morgan's **Global Insurance Solutions Group** is dedicated to delivering customized and integrated solutions to insurers globally.

FOR MORE INFORMATION

Please contact Wheatley Garner, *Global Insurance Solutions*, at wheatley.garner@jpmorgan.com or our accounting & regulatory reporting team at investment.accounting@jpmorgan.com

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

- Feedback to the Capital Adequacy Task Force (CAdTF) in response to CAdTF considering formally integrating bond Risk-Based Capital (RBC) factors for all funds that predominantly hold bonds into the RBC framework was mostly supportive, while some highlighted the issues of treating instruments that are more similar to equity holdings as debt instruments
- The Health Risk-Based Capital Working Group (HRBCWG) continued discussions on the proposed bond structure (i.e., expansion from 6 to 20 risk factors) for the health RBC formula, specifically addressing topics pertaining to investment income; factors for AAA and AA+ bonds; and the inclusion of the bond portfolio adjustment within the factors for speculative-grade (NAIC 3-6) bonds
- The Life Risk-Based Capital Working Group (LRBCWG) rejected the proposal put forth earlier this year to reduce the RBC charge for unaffiliated equities held over a long horizon
- The American Council of Life Insurers (ACLI) and North American Securities Valuation Association (NASVA) proposed that structured notes receive equity-like RBC charges due to the current RBC rules for derivatives being incompatible with structured notes

Feedback to the Capital Adequacy Task Force (CAdTF) in response to CAdTF considering formally integrating bond RBC factors for all funds that predominantly hold bonds into the RBC framework was mostly supportive, while some highlighted the issues of treating instruments that are more similar to equity holdings as debt instruments

Earlier this year, the Valuation of Securities Task Force (VOSTF) requested that the CAdTF consider further integrating comprehensive instructions for funds into the RBC framework, with the goal of accommodating all funds, regardless of the schedule they are reported on (e.g., Schedule BA, D-1 or D-2-2), that predominantly hold bonds or preferred stock[1].

The CAdTF requested feedback from the industry on the issue to gauge sentiments on the matter. Most feedback was supportive of the change with comment letters highlighting the benefits, which gives insurance companies better access to diversification and solid risk-

[1] Along with being assigned an NAIC designation by the NAIC Securities Valuation Office ("SVO").

J.P.Morgan
Asset Management

adjusted returns, as well as the positives related to liquidity and the cash flows streams that can be provided. This, along with the cost efficiencies offered by fund structures in comparison to individual bond purchases, is also mentioned as hugely beneficial for small and medium-sized insurers. It was also noted that the current RBC framework seems to be unnecessarily punitive to certain fund structures versus others, even though the underlying bond holdings could be similar or identical.

Commenters also cited that applying bond RBC factors to SVO-assigned designated funds is not a foreign concept and is consistent with current investment RBC procedures for life insurance companies. So while the decision to change the RBC charges themselves is a relevant conversation, it should be separate from the task of incorporating NAIC designations for bond/preferred stock funds and ETFs into the RBC formulas for all insurance types.

Dissenters of the proposal highlighted that the investment characteristics of funds, particularly open-ended funds, are those of equity interests and not debt instruments. Funds do not embody a creditor relationship as defined in SSAP 26 and do not have the same predictability and periodicity of cash flows of actual bonds, which the SVO has cited as its standard for categorizing an asset as debt. It was also noted that open-ended funds have indeterminate lives (i.e., no fixed maturity) and are subject to market forces that will force loss-taking unlike bonds, which, if held to maturity, are immune from market price volatility.

Discussions on this initiative will continue into 2020 as part of CAdTF's current agenda, as the working group continues to work toward the development of appropriate risk factors.

The Health Risk-Based Capital Working Group (HRBCWG) continued discussions on the proposed bond structure (i.e., expansion from 6 to 20 risk factors) for the health RBC formula, specifically addressing topics pertaining to investment income; factors for AAA and AA+ bonds; and the inclusion of the bond portfolio adjustment within the factors for speculative grade (NAIC 3-6) bonds

The HRBWG continued discussions on the proposed bond structure and instructions for the 20 designations for NAIC bonds and recommended factors. Three items of note were addressed in response to industry comments:

1. The treatment of investment income—if investment income is included in the current health formula
   - Investment income (i.e., bond coupon payments) was not reflected in the development of the bond risk factors for the life RBC formula, except to a very limited extent, with the rationale being that any profit from investments is fully distributed to policyholder dividends or used to absorb product or operational losses.
   - Commenters remarked that this did not seem relevant to health RBC, and wondered whether the proposed health bond risk factors reflect investment income, remarking that it seemed appropriate that it be included.
   - The HRBCWG mentioned that this would need to be researched but openly wondered whether it would be a valuable use of resources if the broad impact would be minimal. This is likely to be further addressed only if the impact is deemed considerable.
2. The proposed factor of 0.10% for AAA and AA+ bonds
   - For the AAA and AA+ rating classes, the Academy's report[2] indicated risk factors of zero percent. For reasons of conservatism, the Academy imposed a minimum risk factor of 0.10%, which is also the factor for the AA rating class.
   - To reflect that AAA and AA+ classes are less risky than AA, a commenter suggested factors of 0.03% for AAA and 0.07% for AA+, based on the same proportions as represented in Academy's proposed factors for property & casualty (P&C) RBC.
   - In considering the minimum risk charge, the Academy highlighted in its reasoning the risk charge associated with cash (proposed at 0.10%), stating that if cash has a risk charge, then bonds should have a charge at least as great (the charge to cash was initially instituted to account for the risk that cash may be uncollectible if the bank where the cash is deposited becomes insolvent).
3. The inclusion of the bond portfolio adjustment within the factors for speculative-grade (SG) bonds (NAIC 3-6)
   - The final factors for SG bonds presented by the Academy included the same adjustment for portfolio size used for investment-grade (IG) bonds. Respondents to the proposal wondered why that was the case.
   - The Academy noted that both life and P&C utilize a bond size adjustment factor on SG bond factors in their respective formulas. Therefore, from a consistency

[2] An Update to the Property & Casualty and Health Risk-Based Capital Bond Factors: Report to the NAIC Investment Risk-Based Capital (E) Working Group, Health Risk-Based Capital (E) Working Group, and Property and Casualty Risk-Based Capital (E) Working Group: https://www.actuary.org/sites/default/files/files/publications/Report_to_NAIC_IRBC_PCRBC_HRBC_Bond_Factors_July_30.pdf

standpoint, health incorporated a similar type of adjustment on the SG bond factors.

- The Academy also acknowledged that the modeled approach was simplified and identified potential inconsistencies. However, the Academy also noted that its analysis outlined that the approach was deemed reasonable because the bond size factor is based on the total number of issuers (excluding U.S. government issuers), rather than issuers by rating class, and that the proportion of SG bonds is not large for either life or P&C insurers.

Discussions on these items and the expansion of the RBC risk factors will continue into 2020, as the NAIC continues to prioritize its broader efforts at solvency modernization and the revamping of the RBC formula for health, P&C and life insurers.

The Life Risk-Based Capital Working Group (LRBCWG) rejected the proposal put forth earlier this year to reduce the RBC charge for unaffiliated equities held over a long horizon

Earlier this year, the Allstate Corporation put forth a proposal to the LRBCWG 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.).

During a recent LRBCWG conference call, the working group discussed the proposal and comments received on the topic. Regulators noted that while Allstate did a good job of presenting the history of stock market performance over the long term, concerns still remained that there needed to be an equal analysis of theory to prevent an unreasonable result where money can be borrowed at a low rate with a guarantee of a higher rate over time. Regulators also expressed fears on how this would affect the solvency of companies during times of extreme stress in equity markets. RBC ultimately remains a tool regulators use to identify companies that may be weakly capitalized. A key concern with reducing RBC is whether it could lead to scenarios where a company is insolvent but has a healthy RBC. This would be an extreme example, but it's not out of the realm of possibility, as severe scenarios do happen, even though they are never regarded as likely.

Another concern mentioned by regulators was companies using equities in a way that may not be appropriate for the liabilities they are backing and then, at the end of the year, trade to something for the purpose of RBC and then going back afterward.

Ultimately, regulators decided to reject the proposal, as they were not able to gain comfort with the proposal in its current form. They expressed the need for a more independent, rigorous analysis to consider picking this issue up again in the future.

The American Council of Life Insurers (ACLI) and North American Securities Valuation Association (NASVA) proposed that structured notes receive equity-like RBC charges due to the current RBC rules for derivatives being incompatible with 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[3]. In response to the changes, considerations needed to be made for the appropriate RBC charges and the elements used in determining the RBC.

In a comment letter to CAdTF, the ACLI and NASVA proposed that in situations where an insurer is permitted to hold a structured note as an admitted asset[4], the RBC rules treat such instruments similar to equity securities and apply the highest applicable RBC charge (e.g., life RBC of 30%). Reasons for their support for an equity-like RBC charge, as opposed to typical Schedule DB derivative RBC charges, were that it would provide more comparability to those insurers who are not allowed admissibility and must non-admit the investments (i.e., 100% reduction to Statutory Capital), along with current derivative RBC not being compatible with structured notes. The existing RBC rules for derivatives in SSAP 86 consider whether the book-adjusted carrying value is positive or negative and amount of collateral posted. Negative fair values and posted collateral aren't relevant to structured notes.

This item will remain part of CAdTF's active agenda but is considered low priority at this juncture as other agenda items take precedence.

[3] 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 or U.S. TIPS), are considered derivative instruments, captured in scope of SSAP No. 86 – Derivatives.

[4] The Statutory Accounting Principles Working Group (SAPWG) also adopted during the Fall National meeting a clarification to the applicable accounting guidance that when a derivative is not used for Hedging, Income Generation or Replication (which would include structured notes), it is required to be reported at fair value and is a non-admitted asset per the guidance in SSAP 86. NAIC staff noted that they will continue to monitor unintended consequences of the adoption and may re-examine this as interested parties provide additional feedback and examples.

GIS_NAIC-CFD_0120 | 0903c02a827ac162