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INSURANCE REGULATORY UPDATE

Takeaways from 2023 NAIC Spring Meeting

The National Association of Insurance Commissioners' (NAIC) spring meeting took place March 20–25 in Louisville, Kentucky. Below we summarize some of the relevant developments.

Negative Interest Maintenance Reserve is at the Forefront Again

With interest rates much higher than only a year ago, a significant portion of life insurers' bond portfolios has swung from unrealized gain to unrealized loss. Insurers selling bonds at a loss today would be required to reflect the realized loss in their capital and surplus positions immediately, creating a perception of decreased financial strength.

This has made recognizing a net negative interest maintenance reserve (IMR) a hot topic again. It had been a non-issue for many years, with interest rates low and falling. The Statutory Accounting Principles Working Group (SAP WG) addressed the IMR during the session on March 22. A discussion of comments submitted by the American Council of Life Insurers (ACLI) highlighted the urgency of the situation, putting a new impetus on developing a solution before the end of the year.

However, it's important to incorporate appropriate safeguards when allowing negative IMR. One proposal is a cap on the negative IMR as a percentage of surplus. Several percentages have been proposed, from as low as 1% to as high as 10%. Participants zeroed in on 5% as the most logical number for several reasons, not the least one being that 5% of surplus is a materiality threshold in some states.

Other potential safeguards are:

- Allowing negative IMR only if it's included in asset adequacy testing (AAT)
- Allowing negative IMR only for companies with strong risk-based capital (RBC) positions
- Ensuring that fixed income sales are reinvested in new fixed income securities
- An "opt-in" approach, which centers on documentation, controls, governance and regulatory reviews
- Creating a special surplus account for negative IMR
- Shortening the amortization period for negative IMR

The ACLI comment letter spoke out against the last two proposed safeguards.

Exclusion for Nominal Interest Rate Adjustments under Principles-Based Bond Definition

The SAP WG reacted to the February 10, 2023 comment letter from interested parties—Travelers and Equitable—adding a limited exclusion for nominal interest-rate adjustments to the proposed draft of SSAP 26R. These are adjustments to principal or coupon that are too small to be significant in deciding whether a given security is a bond in substance. They typically don't intend to significantly modify the security's return from the investor's perspective; the goal is usually to incentivize a specific issuer behavior. So, securities falling under the nominal interest rate adjustments umbrella will still be treated as bonds. For example, sustainability-linked bonds are now spelled out as bonds. These changes will be re-exposed for comments until June 9, 2023.

CLO Modeling and Treatment of Residual Tranches

The Risk-Based Capital Investment Risk and Evaluation Working Group (RBCIRE WG) continued debating the details of modeling collateralized loan obligations (CLOs) for RBC purposes. A few of the questions not yet answered include:

- What should the models' specifications be?
- How can a structure and methodology for CLO modeling be created that can be adapted for other structured assets?
- Should modeling be outsourced, similar to the current approach for RMBS and CMBS, or should it be handled internally by the Structured Securities Group (SSG)?
- How should the NAIC define the very concept of RBC arbitrage that it's trying to eliminate? (Everyone seems to have a different definition.)

A separate but related discussion topic was the interim solution for residual tranches. The RBCIRE WG has again confirmed that it's tasked with finding an approach for residual tranches of all securitized assets, not just CLOs. As CLO modeling is finalized, CLOs are expected to fall out of scope. On the other hand, the interim solution may stick around a lot longer for assets lacking the volume to warrant separate modeling.

The key input for the interim solution is accurate data on residual tranches held by insurers. Last year, the SAP WG moved all residual tranches to Schedule BA for year-end 2022 reporting. As the 2022 statutory data is released, it will be much easier to evaluate the exposure. Once the data are available, it would become the basis for setting the appropriate capital factor—perhaps even for deciding whether residual tranches are material enough to warrant implementing the interim solution in the first place. There's some ambiguity on what constitutes a residual tranche, so the definition needs to be refined, with several participants pointing out that residual tranches would probably be underreported for year-end 2022 as a result. In any case, the materiality of residual tranches will likely keep increasing in 2023 and beyond. Additionally, it was suggested that instead of looking at materiality from the industry-average perspective, it would be more sensible to look at individual companies with material allocations to residual tranches.

The Working Group intends to proceed with a proposal for a single NAIC6 category, instead of the earlier idea of creating three NAIC6 sub-categories. The increased capital charge will be supplemented by sensitivity tests. A 45% pre-tax capital charge for life insurers seems to be the lower bound for the discussed range, which extends all the way up to 100%. Some industry participants suggest the need for more differentiation, because not all residual tranches are created equal. For example, a residual tranche of a collateralized fund obligation (CFO) can be viewed as "equity on equity," which could require a higher charge than a residual tranche in a CLO structure—or in a fixed income-backed feeder fund.

There's a desire to implement an interim solution for year-end 2023 reporting.

Potential Changes to Risk-Based Capital Methodology and Formula

During the discussion of the current working agenda and priorities by the Life Risk-Based Capital Working Group (Life RBC WG), The American Academy of Actuaries (AAA) made several suggestions that may signal profound long term changes to the risk-based capital (RBC) methodology and formula.

First, the different versions, or "phases", of the C3 calculation may eventually be unified. AAA is ready to start this process by penning down a conceptual proposal. Clearly, this would be a very involved project with many questions unanswered and significant co-dependencies with other workstreams, such as the required economic scenario generator. The ideal end result would be a single, all-encompassing C3 methodology that includes all insurance lines. No timeline has been proposed for this project.

Another aspect of RBC's potential overhaul would be a review of the covariance adjustment, both between different risks and within each risk component. The Academy isn't married to the square-root formula and is willing to explore other ways to address covariance. A good start would be to look at other capital methodologies such as Solvency II, which specifies fixed covariances between risks. Ideally, this work should be coordinated with other RBC Working Groups, with the ultimate goal of synchronizing the covariance approaches for all RBC formulas: life, P&C, and health. The Academy is planning to start this work in 2023.

More generally, 30 years after its debut, the RBC methodology itself is ripe for a holistic reexamination. There's now enough data to try and answer fundamental questions about the effectiveness of the RBC formula, such as:

- Does it effectively serve its main purpose of identifying weakly capitalized companies?
- Does it produce false positives or false negatives?
- What are the inconsistencies between the risk-based capital and statutory reserves or other parts of the balance sheet?

No timeline has been suggested for this methodology review.

Summary: Ongoing Updates…Ongoing Monitoring

No breaking news came out of the 2023 NAIC Spring meeting, but work continues on many regulatory fronts. Market participants received more clarity, status updates, and indicative timelines on several impactful projects the NAIC is working on. In particular, insurers should expect two significant changes to happen sooner than later—possibly in time for 2023 year-end reporting: 1) net negative IMR recognition and 2) a residual tranche interim solution. AB's Insurance Solutions Team will keep a watchful eye on these and other developments, providing real-time regulatory updates to clients.

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