GUGGENHEIM

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Note to Insurance Clients on Potential Revisions to Risk-Based Capital Charges

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Nothing moves quickly in the insurance world, but after 30 years, a change may finally be coming to the National Association of Insurance Companies (NAIC) risk-based capital (RBC) charges on fixed-income securities. These changes may have profound consequences for certain life insurance companies.

We are closely monitoring these developments. While it is uncertain whether the timeline for proposed changes will be met or delayed, we are ready to assist our clients regardless of the outcome.

First a quick history review: Following a wave of insurer insolvencies, in 1991 NAIC developed a six-point designation structure for assessing fixed-income RBC charges. These six designations are still in use today, although largely based on historical data from the 1970s and 1980s. In 2011, NAIC decided to update the capital charges and underlying structure, and the most recent proposal was published on March 25, 2021.

The proposal to update the RBC structure, made by the American Academy of Actuaries (AAA) in consultation with NAIC, would expand the number of RBC charges in the model from six to 20. The rationale for adding more granularity to the risk structure includes a) eliminating NAIC designation “cliffs”, b) aligning better with actual risks, and c) providing for more accurate asset distributions.

In the fall of 2020, NAIC, along with the American Council of Life Insurers, released a request for proposal for an independent review of the proposed bond capital charges. Moody’s Analytics was chosen to provide the review.

On Feb. 11, 2021, the Life RBC Working Group, comprised of state insurance regulators and NAIC staff, met to hear and discuss Moody's initial findings and recommendations. The Moody's presentation identified the following significant deficiencies in the proposal:

1. The model utilized by the AAA to develop the factors did not use best practices for data and modeling.
2. The model documentation did not generally meet financial industry standards.
3. There was a lack of differentiation across asset class, maturity, and investment income offsets.
4. The economic modeling framework did not lend itself to statistical properties of default and recovery dynamics.
5. There was a lack of consideration for climate hazards or other emerging risks.

The Chair of the Working Group directed Moody's to continue the production of an alternative set of factors, which it published on April 13, 2021. The Working Group then scheduled weekly update calls to discuss and debate the two sets of factors over the coming weeks. At the first of these weekly meetings, the working group asked Moody's to lower the discount rate that it used in constructing its factors which served to raise the factors. On April 28, 2021 the working group exposed the updated proposals subject to a 30-day comment period. The overall goal is to approve a set of factors by June 30, 2021, so that they can be implemented for the year end 2021 RBC filing.

We are concerned with this timeline and process for several reasons:

1. Moody's raised legitimate concerns with the AAA's proposal, the regulators' likely preferred option for the update.
2. No comprehensive study has been performed on the impact of the new RBC charges to insurers.
3. The charges have been in place for 30 years and to hastily approve factors in the span of three months seems shortsighted given the importance and long-lasting nature of the update.
4. The timeline does not provide enough time for the industry to react to the final update before implementation.
5. The U.S. insurance industry has nearly $7 trillion dollars in general account assets. Without a phase-in period there is likely to be unintended repercussions on the insurance industry and the capital markets.

6. The project has been ongoing for about a decade, and accuracy should take precedence over expediency given the permanence and importance of the update.
7. The request of Moody's to lower the discount rate, despite them already using a lower rate than the AAA proposal, reinforces the disjointed nature of this process.

At this time, given that the factors are not yet finalized, it is difficult to determine exactly how and if a repositioning of insurance company portfolios is necessary or warranted. However, based on published year-end financial statements, we believe that the AAA proposal as it currently stands could result, on average, in a 35-point reduction in RBC for an annuity-focused life insurer. In fact, the National

Impact to RBC Factors from Published Proposals

		New Factors		Change	
Category	Old Factor	AAA	Moody's	AAA	Moody's
Exempt	0.00%	0.00%	0.00%	nm	nm
1A	0.39%	0.29%	0.16%	-25.64%	-59.49%
1B	0.39%	0.42%	0.27%	7.69%	-30.51%
1C	0.39%	0.55%	0.42%	41.03%	7.44%
1D	0.39%	0.70%	0.52%	79.49%	34.10%
1E	0.39%	0.84%	0.66%	115.38%	68.46%
1F	0.39%	1.02%	0.82%	161.54%	109.23%
1G	0.39%	1.19%	1.02%	205.13%	160.51%
2A	1.26%	1.37%	1.26%	8.73%	0.08%
2B	1.26%	1.63%	1.52%	29.37%	20.87%
2C	1.26%	1.94%	2.17%	53.97%	72.06%
3A	4.46%	3.65%	3.15%	-18.16%	-29.35%
3B	4.46%	4.66%	4.54%	4.48%	1.73%
3C	4.46%	5.97%	6.02%	33.86%	34.91%
4A	9.70%	6.15%	7.39%	-36.60%	-23.86%
4B	9.70%	8.32%	9.54%	-14.23%	-1.70%
4C	9.70%	11.48%	12.43%	18.35%	28.12%
5A	22.31%	16.83%	16.94%	-24.56%	-24.06%
5B	22.31%	22.80%	23.80%	2.20%	6.67%
5C	22.31%	30.00%	30.00%	34.47%	34.47%
6	30.00%	30.00%	30.00%	0.00%	0.00%

Source: NAIC. Data as of 12.31.2020.

Impact to the U.S. Life Industry

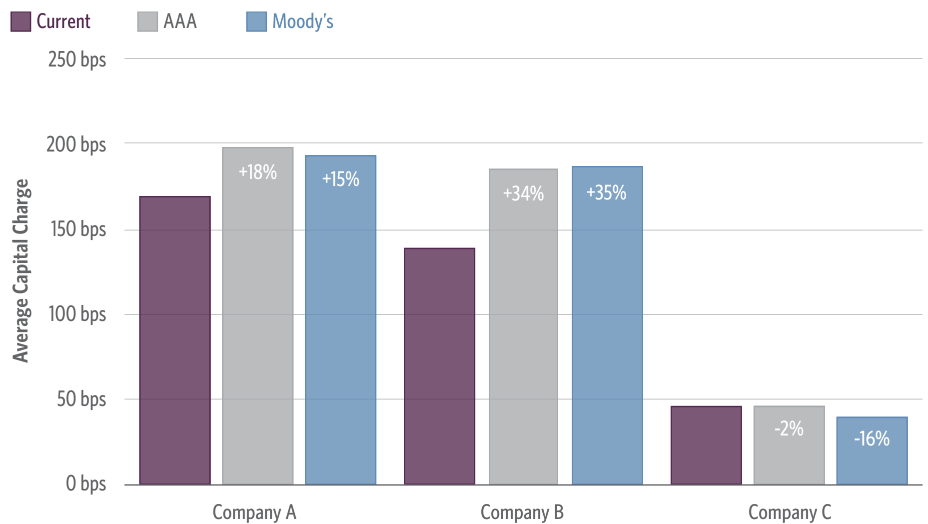
Category	% Stat BV	Required RBC in Basis Points		
		Current	AAA	Moody's
Exempt	5.6%	-	-	-
1A	13%	5	4	2
1B	2%	1	1	1
1C	4%	2	2	2
1D	6%	2	4	3
1E	5%	2	4	3
1F	11%	4	11	9
1G	10%	4	12	11
2A	13%	16	17	16
2B	15%	19	24	23
2C	9%	12	18	20
3A	2%	7	6	5
3B	1%	5	6	5
3C	1%	6	8	8
4A	0%	5	3	3
4B	1%	7	6	7
4C	0%	4	5	5
5A	0%	4	3	3
5B	0%	6	7	7
5C	0%	1	2	2
6	0%	2	2	2
Total	100%	114	145	137
Change			26%	19%

Source: SNL, Year-end 2020 Life Industry Aggregate.

Alliance of Life Companies submitted a comment letter indicating that a survey of its members showed a 6.6–11.1 percent increase in required capital, or a 26–45-point reduction in the RBC ratio for an insurer with a 400 percent RBC ratio. As the following table shows, the life industry would have to set aside an additional 26 percent in RBC for the assets subject to this proposal, raising the C-1 charge from 114 basis point to 145 basis points. The Moody's proposal is less deleterious by comparison on average, but still results in an increase of 19 percent and raises the C-1 charge to 137 basis points.

We are concerned by the order of magnitude of this impact. It would be less worrying if the effect from the proposal had been consistent across the industry, as the industry and its stakeholders would have likely allowed for a parallel industrywide downward shift of the RBC ratio. However, this seems unlikely, and we believe that a tailored approach will be required for each insurer as the impact will vary significantly by company based upon portfolio asset composition and diversification, as well as overall capital position. The following table shows how the new RBC factors will have a varied effect on three different, highly rated, life companies. It is clear that the distribution of holdings within each category will drive different outcomes.

New Capital Charges Will Hurt Some Life Companies More Than Others



Source: SNL, Year-end 2020 Life Industry Aggregate.

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